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United States District Court

Southern District of New York

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc., on behalf of debenture-holders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant.

Extract of Docket Entries in 67 Civ. 1914

May 15, 1967—Filed complaint and issued summons.

September 5, 1967—Filed Application for a judge for all purposes.

September 5, 1967—Filed order referring this case to Judge McLean for all purposes. Sugarman, Ch. J.

November 28, 1967—Filed defendant's affidavit and notice of motion to dismiss complaint, etc.—ret. 12-4-67 at 10:00 A.M. in Room 2704.

November 28, 1967—Filed defendant's memorandum in support of diverse motions.

May 20, 1968—Filed memorandum of Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc. and subsidiaries in opposition to various motions of Marine Midland.

Extract of Docket Entries in 67 Civ. 1914

May 20, 1968—Filed Opinion #34809—Defendant has moved pursuant to Rules 12(b)(6) and 17(a) to dismiss this action on the grounds that the complaint fails to state a claim and that plaintiff is not the real party of interest. Defendant's motions are granted. The action is dismissed. So ordered. McLean, J.

June 13, 1968—Filed Plaintiff's notice of appeal to USCA, mailed copy to Sullivan & Cromwell.

July 24, 1968—Filed Stipulation and Order extending time of plaintiff-appellant-appellant to file the record on appeal to 8-21-68. Mansfield, J.

August 2, 1968—Filed certification of record on appeal to USCA.

April 14, 1971—Filed true copy of USCA order and opinion that orders of USDC are affirmed without costs in accordance with opinion of this Court—Judgment-Clerk m/n.

Extract of Docket Entries in 65-B-365

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

In Proceedings for Reorganization of Corporations pursuant to Chapter X of the Bankruptcy Act

In the Matter

of

WEBB & KNAPP, INC. and Subsidiaries,

Debtors.

April 17, 1967—#330. Filed petition and notice of motion for an order authorizing Trustee to commence an action or assert a counterclaim against and to compel an accounting by Marine Midland Grace Trust Company of New York—returnable April 21, 1967 at 10:00 A.M.

May 16, 1967—#349. Filed objection by Trustee to allowance of claim and counterclaim of Marine Midland Grace Trust Company of New York—McLean, J.

November 28, 1967—#425. Filed notice of motion for an order dismissing counterclaim asserted in the Trustee's pleading for failure to state a claim upon which relief can be granted because the Trustee has no standing to assert against Marine Midland. The claim set forth in the counterclaim, etc.—returnable December 4, 1967 at 10:00 A.M.

May 20, 1968—#472. Filed opinion #34808 granting Marine Midland's motion to dismiss the reorganization Trustee's counterclaim. The motion to strike the reorganization Trustee's objection is denied. Settle order on notice—McLean, J.

Extract of Docket Entries in 65-B-365

May 22, 1968—#474. Filed Opinion #34822 denying Trustee's motion for an order compelling Marine Midland Grace Trust Company of New York to account for its acts as Indenture Trustee. Settle order on notice—McLean, J.

June 7, 1968—#476. Filed affidavit and order #132 denying motion of the Trustee to compel Marine Midland Grace Trust Company of New York [to account as Indenture Trustee]—McLean, J.

June 7, 1968—#477. Filed affidavit and order #133 re motion of Marine Midland Grace Trust Company of New York, Ordered that the motion to dismiss the counterclaim is granted, and that the counterclaim is hereby dismissed, and it is further ordered that the motion to strike the objection is denied—McLean, J.

June 13, 1968—#478. Filed notice of appeal from order #132 (paper #476).

June 13, 1968—#479. Filed notice of appeal from order #133 (paper #477).

Above two notices filed by Marshall, Bratter, Greene, Allison & Tucker, 430 Park Avenue, New York, New York 10022—a copy of each mailed to Sullivan & Cromwell, Esqs., 48 Wall Street, New York, New York 10005.

July 3, 1968—#499. Filed notice of appeal from order #133 (paper #477) filed by Sullivan & Cromwell, Esqs., 48 Wall Street, New York, New York—mailed copy to Marshall, Bratter, et al., 430 Park Avenue, New York, New York 10022.

Proof of Claim filed by Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations pursuant to Chapter X of the Bankruptcy Act

In the Matter of

WEBB & KNAPP, INC.,

52026 COPORATION

WEBB & KNAPP SOUTHWEST NUMBER THIRTEEN CORPORATION,

WEBB & KNAPP SOUTHWEST NUMBER FOURTEEN CORPORATION,

WEBB & KNAPP SOUTHWEST NUMBER FIFTEEN CORPORATION,

WEBB & KNAPP SOUTHWEST NUMBER SIXTEEN CORPORATION, and 91234 CORPORATION,

Debtors.

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

FRANK C. STRAAT, residing at No. 327 Byron Place, Borough of Maywood, County of Bergen, State of New Jersey, being duly sworn, deposes and says:

1. I am a Vice President of Marine Midland Grace Trust Company of New York (hereinafter "Marine Midland"), a banking corporation organized and existing under the laws of the State of New York, having its principal place of business at No. 120 Broadway in the City,

County and State of New York and formerly known as The Marine Midland Trust Company of New York. I am duly authorized to make this proof of claim.

2. Webb & Knapp, Inc., one of the above-named debtors (hereinafter the "Debtor"), was at and before the filing of the petition herein for its reorganization under Chapter X of the Act of Congress relating to bankruptcy, and still is, justly and truly indebted to Marine Midland in the sum of $51,447.55.

3. The consideration of said debt is as follows: Marine Midland is Indenture Trustee of the Debtor under an Indenture dated as of June 1, 1954 pursuant to which the Debtor issued securities, namely, 5% Sinking Fund Debentures due June 1, 1974 and the coupons thereto attached in the instance of Debentures issued with coupons attached. A copy of the Indenture, duly certified by the undersigned, is annexed hereto and made part hereof as Exhibit A. In its capacity as Indenture Trustee, Marine Midland rendered services, made disbursements and incurred expenses prior to May 7, 1965, the date of the filing of the petition for reorganization herein. On or about August 19, 1964, Marine Midland mailed to the Debtor its statement dated August 19, 1964, in the amount of $19,248.14, for its services (including extraordinary services), disbursements and expenses as Indenture Trustee for the period December 1, 1963 to May 31, 1964; on or about January 14, 1965, Marine Midland mailed to the Debtor its statement dated January 14, 1965, in the amount of $8,438.97, for its services (including extraordinary services), disbursements and expenses as Indenture Trustee for the period June 1, 1964 to November 30, 1964; Marine Midland prepared, but did not mail to the Debtor, a statement dated May 6, 1965, in the amount of $12,829.84, for its services (including extraordinary serv-

ices), disbursements and expenses as Indenture Trustee for the period December 1, 1964 to May 6, 1965. In addition, Marine Midland has received a statement from its counsel for legal fees and expenses payable by the Indenture Trustee in the total amount of $24,189.14, of which I am informed and believe $10,930.60 is attributable to services rendered and disbursements and expenses incurred on behalf of the Indenture Trustee prior to May 7, 1965 and the balance is attributable to services rendered and disbursements and expenses incurred in connection with the reorganization proceedings herein, including, among other things, preparation and filing of the petition for reorganization, the affidavit pursuant to Rule X-4 of the Bankruptcy Rules of this Court, the Indenture Trustee's statement pursuant to Section 211 of the Bankruptcy Act, conferences in chambers concerning the petition for reorganization and the form of orders to be signed, and preparation of the order approving the petition for reorganization and appointing the Trustee of the Debtor, all of which were for the direct benefit of the estate of the Debtor. Application to this Court for the allowance of such balance as reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred to May 31, 1965 in connection with the administration of the estate of the Debtor will be made by the Indenture Trustee. Copies of the statements hereinbefore mentioned are annexed hereto and made part hereof as Exhibits B, C, D and E, respectively.

4. No part of said debt has been paid.

5. There are no set-offs or counterclaims to said debt.

6. Marine Midland does not hold and has not, nor has any person by its order, or, to the knowledge or belief

of the undersigned, for its use, had or received, any security or securities for said debt except Marine Midland has the right to a lien pursuant to the terms of the aforementioned Indenture upon all securities and other considerations to which the holders of the Debentures may become entitled herein, plus such other security as the terms of said Indenture may afford Marine Midland.

7. A copy of the Indenture, the instrument upon which said debt is founded, is annexed hereto and made part hereof as Exhibit A. The original of the Indenture is in the possession of Marine Midland and will be exhibited on request.

8. Marine Midland makes this proof of claim without prejudice to and with reservation of its rights against any and all persons who may be liable in respect of the subject matter of this proof of claim.

9. Marine Midland reserves its rights to amend this proof of claim in any respect at any time or times.

FRANK C. STRAAT
Frank C. Straat
Vice President
Marine Midland Grace Trust
Company of New York

(Subscribed and sworn to June 14, 1966.)

Exhibit A to Proof of Claim

(Indenture which is part of the proof of claim and marked Exhibit "A" thereto is not included herein. Copies of the indenture will be submitted to the Court pursuant to Rule 38.)

Exhibit B to Proof of Claim

Please retain the bill and return this stub with your remittance. Unless requested, we will not send you a receipt as our endorsement on your check will serve this purpose.

Enclosed check for $19,248.14 covers Services & Disbursements.

Name Webb & Knapp, Inc.

Ref. Corporate Trust 8/19/64 Office Main.

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK
NEW YORK, N. Y.

August 19, 1964

Webb & Knapp, Inc.
383 Madison Avenue
New York 17, New York

For ordinary services as Trustee for period December 1, 1963 to May 31, 1964 including extraordinary services.		
Bond Interchange Transactions		
Authentication of Debentures a/c of transfer. 45 debentures authenticated @ 50¢ each	$	22.50
For services rendered in the redemption of scrip certificates.		
11 lots @ 50¢ each		5.50
For sorting, listing and cremating 9136 cancelled 5% Sinking Fund Coupons as per cremation certificates dated December 18, 1963 @ $10.00 per 1,000		91.36
For sorting, listing and cremating cancelled 5% Sinking Fund Bonds as per cremation certificate dated April 17, 1964. Minimum Fee		10.00

Exhibit B to Proof of Claim

For the preparation of a list of registered holders as of record May 29, 1964 forwarded to Bankers Trust Co.	
665 holders @ $25.00 per 1,000	16.63
For services rendered in connection with the redemption of $430,400 principal amount of 5% Debentures due 6/1/74 account of Sinking Fund due 6/1/64 @ ⅛ of 1%	538.00
For the maintenance of Debentureholders accounts for year ending May 31, 1964. 715 accounts maintained @ 50¢ each	357.50
Annual Administration services under Indenture of Mortgage dated June 1, 1954, payable (in advance) for the period June 1, 1964 to May 31, 1965.	
$4,298,200 principal amount of Debentures outstanding @ $225 per million	967.10
Minimum annual fee (in advance) for acting as Registrar as to principal only and principal and interest, including the registration of 150 Debentures	150.00
Additional services as Trustee not falling within the area of ordinary administrative functions were required commencing with May 25, 1964 when it was first learned that the company would not be able to make the Sinking Fund payment due on that date, which was followed by the announcement on or about May 27th that the company also would not be able to meet the semi-annual interest payment due June 1, 1964. This involved immediate review of the Indenture provisions governing this situation, conferences with counsel, company officials and their counsel, meet-	

ing of senior officers and a report to the Officers' Trust Committee, and preparation of notice dated June 3, 1964 pursuant to Section 10.3 of the Indenture. (At this particular time the Trustee was awaiting details of the company's plan for altering the provisions of the Indenture, which it understood they intended to submit to a Debentureholders' meeting.) A meeting with the company on June 11th revealed a change in their plans involving not calling any Debentureholders' meeting and signifying that interest would be paid before expiration of the grace period and the Sinking Fund would be paid by July 31, 1964. The Trustee requested and received and reviewed at length certain data to assist it in determining courses of action which might be followed after June 30th when, under the most liberal interpretation of the Indenture, the Sinking Fund default grace period would expire. The Trustee determined that for the present it would not accelerate the entire indebtedness in consideration of the interest payment having been made and expectation that the Sinking Fund payment would be made as promised. A letter to Debentureholders was prepared which was dated July 14th. During the latter stages of the month many disturbing developments were dealt with as they arose, including knowledge that judgments were being obtained, restraints were being levied against accounts of the company; such restraints were being vacated and the filing of a bankruptcy petition under Chapter XI by Zeckendorf Hotels Corporation. Continual review, discussions and decisions were required on a daily basis involving senior officers, Executive Committee and Corporate Trust officers and counsel to and including July 31st, the date on which the Sinking Fund payment was made $7,500.00 $9,658.59

Exhibit B to Proof of Claim

DISBURSEMENTS.

Stationery, etc.	$ 69.67	
Professional services and disbursements of Messrs. Sullivan & Cromwell as per attached statement	8,358.53	
Payment to Albert Frank-Guenther Law, Inc. for printing Redemption notice	1,016.92	
Registered mail charges (postage used)	144.43	$ 9,589.55
		$19,248.14

Exhibit B to Proof of Claim

SULLIVAN & CROMWELL

48 WALL STREET,

NEW YORK 5

August 14, 1964

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK

to

Sullivan & Cromwell,

DUPLICATE

In full for professional services from June 1, 1964 to and including July 31, 1964 in connection with your trusteeship under the Webb & Knapp Indenture of June 1, 1954.

Our Fee, ...	$6,000.00
Miscellaneous disbursements, copying and typewriting ..	343.03
	6,343.03
To statement rendered June 1, 1964	2,015.50
	$8,358.53

Exhibit B to Proof of Claim

SULLIVAN & CROMWELL

CABLE ADDRESS: "LADYCOURT", NEW YORK

48 WALL STREET,

NEW YORK 5

June 1, 1964

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK
in account with Sullivan & Cromwell,

DUPLICATE

In full for our professional services rendered from February 28, 1963 through May 31, 1964, to you as Trustee under the Indenture with Webb & Knapp, Inc., involving study, conferences and advice with respect to financial difficulties of Webb & Knapp and the construction and operation of provisions of the Indenture.

Our Fee, ...	$2,000.00
Miscellaneous disbursements, copying and typewriting ..	.15.50
	$2,015.50

Exhibit C to Proof of Claim

Please retain the bill and return this stub with your remittance. Unless requested, we will not send you a receipt as our endorsement on your check will serve this purpose.

Enclosed check for $8,438.97 covers Services & Disbursements

Name Webb & Knapp, Inc.

Ref. Corporate Trust Office Main

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK
NEW YORK, N. Y.

January 14, 1965

Webb & Knapp, Inc.
383 Madison Avenue
New York 17, New York

For services as Trustee under Indenture of Mortgage dated June 1, 1954, period June 1, 1964 to November 30, 1964.

Bond Interchange Transactions

Authentication of Debentures account of transfers, exchange or split-ups.		
162 Debentures authenticated @ 50¢ each	$	81.00
For services rendered in redemption of Scrip certificates.		
19 lots @ 50¢ each		9.50
For the preparation and mailing of Trustee's Annual Report as of September 1, 1964. Minimum fee		25.00
For the preparation of a list of registered holders as of record November 23, 1964.		
579 accounts @ $25.00 per 1,000		14.48

Exhibit C to Proof of Claim

Additional services as Trustee not falling within the area of ordinary administrative functions were required throughout the period from August 1, 1964 to November 30, 1964. Under instructions of our Executive Committee due to the continuance of defaults under the Indenture, we were required to make weekly reports of discussions between our officers and senior officers of the company concerning any adverse developments which might come to our attention, as well as the company's progress toward refinancing or liquidating their overdue obligations and their negotiations to dispose of major properties. During this period we were served with six Restraining Notices against the Webb & Knapp, Inc. account and we followed closely each one until we were notified that such notices were vacated. It was not until October 7th that we finally received the annual Compliance Certificates pursuant to Section 3.6 of the Indenture which had originally been requested on June 15th and this matter had to be followed assiduously. Special attention had to be directed to the preparation of the Trustee's Annual Report to Debentureholders pursuant to Section 10.10 of the Indenture to acquaint the Debentureholders of the facts concerning the defaults known to us. We also prepared a brief notice to Debentureholders dated August 12, 1964 concerning the availability of funds for interest and Sinking Fund. We received specific financial information in written form under the dates of August 26th and October 13th and each letter was studied in detail, brought to the attention of senior officers and the Executive Committee and counsel $5,000.00 $5,129.98

Exhibit C to Proof of Claim

DISBURSEMENTS

Stationery, etc.	$ 6.25	
Professional services and disbursements of Messrs. Sullivan & Cromwell as per attached statement	2,608.19	
Payment to Appeal Printing Co. for printing Notice of Holders dated June 3, 1964 and July 14, 1964	362.96	
Payment to Appeal Printing Co. for printing Notice to Holders dated August 12, 1964	93.60	
Payment to Bowne & Co., Inc. for printing copies of Annual Trustee's Report	60.32	
Payment to American Banknote Co. for 300 $100 Denomination registered debentures	130.00	
Postage used in mailing Trustee's Annual Report	41.85	
Registered mail charges (postage used)	5.82	$3,308.99
		$8,438.97

Exhibit C to Proof of Claim

SULLIVAN & CROMWELL

CABLE ADDRESS: "LADYCOURT" NEW YORK

48 WALL STREET

NEW YORK 5

December 1, 1964

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK

in account with Sullivan & Cromwell,

DUPLICATE

In full for professional services from August 1, 1964 to and including November 30, 1964 in connection with your trusteeship under the Webb & Knapp Indenture of June 1, 1954.

Our Fee, ...	$ 2,500.00
Miscellaneous disbursements, copying and typewriting ..	108.19
	2,608.19
To statement rendered June 1, 1964	2,015.50
To statement rendered August 14, 1964	6,343.03
	$10,966.72

Exhibit D to Proof of Claim

Please retain the bill and return this stub with your remittance. Unless requested, we will not send you a receipt as our endorsement on your check will serve this purpose.

Enclosed check for $12,829.84 covers Services & Disbursements
Name Webb & Knapp, Inc.
Ref. Corporate Trust Office Main

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK
NEW YORK, N. Y.

May 6, 1965

Webb & Knapp, Inc.
383 Madison Avenue
New York 17, New York

For services as Trustee under Indenture of Mortgage dated June 1, 1954, period December 1, 1964 to May 6, 1965:

Bond Interchange Transactions

Authentication of Debentures account of transfers, exchange or split-ups.

159 debentures authenticated @ 50¢ each	$	79.50
For services rendered in redemption of Scrip Certificates.		
16 lots @ 50¢ each		8.00
For sorting, listing and cremating 8458 cancelled 5% Sinking Fund Coupons as per cremation certificate dated December 3, 1964 @ $10.00 per 1,000		84.58
Additional services as Trustee not falling within the area of ordinary administrative functions for the period from December 1, 1964 to and including May 6, 1965, including:		

Exhibit D to Proof of Claim

Continued weekly reports covering discussions between our offices with one or more of the senior offices of the company to determine to our satisfaction in reporting to our Executive Committee whether any current developments might be considered sufficiently adverse to require drastic action; to consult with our counsel and make reports for the files with regard to any refinancing or liquidations of debt of which we learned or bankruptcies of subsidiaries, including a complete review of the Paramount transaction and the March, 1965 British and Bankers Life & Casualty refinancings; reviewing and following closely 8 restraining notices against the account of Webb & Knapp, Inc. until all were vacated (one has not been vacated to date); preparation of December 4, 1966 and January 12, 1965 notices to Debentureholders re interest payment and other defaults; consideration of publicity concerning repledging of certain collateral, drafting December 3rd letter to company and receiving December 18th reply; drafting letter of January 11th and receiving the company's January 26th reply concering the updating of certain defaults; consideration of copy furnished to us by the company of its letter of January 22nd to Value Line Investment Fund, resulting in our drafting a request dated January 29th for further information (no reply ever received in writing); preparation of April 16th notice to company regarding forthcoming Sinking Fund; preparation of April 22nd notice to the company regarding compliance with Section 5.3 of the Indenture and finally the receipt of company's letter dated April

29th concerning such Section and authorizing our action to draw Debentures; receipt from Webb & Knapp, Inc. May 4th in the afternoon of copies of Gulf States Land & Industries, Inc. prospectus dated April 21, 1965; subsequent conferences with our counsel and the calling of special Executive Committee meeting of May 5th; and conferences among the senior officials of the bank with regard to the publicity surrounding the suspension of trading securities of Webb & Knapp, Inc. on the American Stock Exchange and the SEC Order for temporary suspension of trading through any medium of the securities of Webb & Knapp, Inc. on May 4 and May 5th. During all of this period our Executive Committee met 23 times in regular session and 2 times in extraordinary session and at each meeting devoted considerable attention to Webb & Knapp, Inc. reports made by the officers of the company	$12,000.00	$12,172.08

DISBURSEMENTS

Stationery, etc.	$ 44.59	
Payment to Appeal Printing Co. for 1000 Notice to Holders dated 12/4/64	135.20	
Payment to Appeal Printing Co. for 1000 Notice to Holders dated January 12, 1965	87.36	
Payment to Herald Tribune for publishing redemption notice on May 1, 1965	275.00	
Postage used in mailing Notice to Holders and Redemption Notices	88.09	
Mail charges (postage used)	27.52	657.76
		$12,829.84

Exhibit E to Proof of Claim

SULLIVAN & CROMWELL

CABLE ADDRESS: "LADYCOURT" NEW YORK

48 WALL STREET

NEW YORK 5

September 21, 1965

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK
in account with Sullivan & Cromwell,

In full for our professional services rendered from December 1, 1964 to May 31, 1965 to you as Trustee under the Webb & Knapp Indenture dated as of June 1, 1954.

Our services included: advising the Bank generally and specifically with respect to the discharge of its trusts under the Indenture; calls, conferences and correspondence with Bank officers and with representatives of Webb & Knapp, Inc. concerning the latter's affairs and condition; investigating and reviewing facts relating to possible defaults by Webb & Knapp, Inc. with respect to its obligations under the Indenture and advising the Bank with respect thereto; upon determining that the interests of debenture holders so required, preparing papers necessary to accelerate Webb & Knapp's obligation to discharge the outstanding debentures; preparing and filing complaint against Webb & Knapp, Inc. seeking payment of its obligations to debenture holders; preparing and filing papers necessary to commence proceedings under Chapter X of the Bankruptcy Act with respect to Webb & Knapp, Inc. in the United States District Court for the Southern District of New York.

Our Fee, ... $22,500.00

Exhibit E to Proof of Claim

DISBURSEMENTS

Paid Clerk of the United States District Court for the Southern District of N. Y. for filing fees	$120.00	
Photostating and reproducing documents	647.09	
Miscellaneous disbursements, copying and typewriting	922.05	1,689.14
		$24,189.14

Notice of Motion for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim and to Compel an Accounting by Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations pursuant to Chapter X of the Bankruptcy Act.

In the Matter

of

WEBB & KNAPP, INC., and subsidiaries,

Debtors.

Sirs:

PLEASE TAKE NOTICE, that upon the annexed petition of Mortimer M. Caplin, duly verified the 12th day of April, 1967, and upon all proceedings heretofore had herein, the undersigned will move before Honorable Edward C. McLean, United States District Judge for the Southern District of New York at the United States Court House, Room 619, Foley Square, New York, New York, on the 21st day of April, 1967 at 10:00 o'clock in the forenoon of that day, or as soon thereafter as counsel can be heard, for an order authorizing the Trustee to commence an action or assert a counterclaim against, and to compel an accounting by Marine Midland Grace Trust Company, and for such other and further relief as to the Court may seem just and proper.

Dated: New York, New York.
April 14, 1967

Notice of Motion for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim and to Compel an Accounting by Marine Midland Grace Trust Company of New York

Yours, etc.

MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER
Attorneys for the Trustee
430 Park Avenue
New York, New York 10022
421-7200

To:

SULLIVAN & CROMWELL, Esqs.
Attorneys for the Marine Midland Trust Company of New York
Indenture Trustee
48 Wall Street
New York, New York

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
225 Broadway
New York, New York
Attention: Richard V. Bandler, Esq.

MAURICE ISERMAN, Esq.
Attorney for Debtors and Attorney for Webb & Knapp Profit Sharing Trust
60 East 42nd Street
New York, New York 10017

CRAVATH, SWAINE & MOORE, Esqs.
Attorneys for Chemical Bank New York Trust Company
One Chase Manhattan Plaza
New York, New York

CHARLES M. GOLDMAN, Esq.
Attorney for Certain Preferred Stockholders
89 State Street
Boston, Massachusetts

Notice of Motion for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim and to Compel an Accounting by Marine Midland Grace Trust Company of New York

FRANK A. BYRNES, Esq.
Attorney for New York Life Insurance Company
51 Madison Avenue
New York, New York

DAVID A. ROSENBERG, Esq.
Attorney for Ingersoll-Rand Financial Corporation
11 Broadway
New York, New York 10004

SECRETARY OF THE TREASURY
TREASURY DEPARTMENT
Washington, D. C.

ROYALL, KOEGEL & ROGERS, Esqs.
Attorneys for National Bankers Life Insurance Co.
200 Park Avenue
New York, New York

STRASSER, SPIEGELBERG, FRIED & FRANK, Esqs.
Attorneys for James M. Jacobson
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Notice of Motion for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim and to Compel an Accounting by Marine Midland Grace Trust Company of New York

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Notice of Motion for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim and to Compel an Accounting by Marine Midland Grace Trust Company of New York

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Petition for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim against, and to Compel an Accounting by Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations pursuant to Chapter X of the Bankruptcy Act

In the Matter

of

WEBB & KNAPP, INC. and subsidiaries,

Debtors.

To: THE HONORABLE EDWARD C. MCLEAN, JUDGE OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

The petition of MORTIMER M. CAPLIN, Trustee of the Debtors, respectfully states:

1. On May 7, 1965, the Marine Midland Trust Company of New York ("Indenture Trustee"), as trustee pursuant to an indenture dated as of June 1, 1954 ("Indenture"), providing for the issuance of 5% Sinking Fund Debentures due June 1, 1974 ("Debentures") of Webb & Knapp, Inc. ("Debtor"), filed a petition in the United States District Court for the Southern District of New York ("Court") for the reorganization of the Debtor pursuant to Chapter X of the Bankruptcy Act.

2. On May 18, 1965, by Order No. 3 of the Court, Mortimer M. Caplin was appointed Trustee of the Debtor, duly

Petition for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim against, and to Compel an Accounting by Marine Midland Grace Trust Company of New York

qualified thereafter and has continued since then to act as such Trustee.

3. Petitioner seeks the Court's authorization to institute an action on his own behalf and on behalf of all of the holders of Debentures against the Indenture Trustee for damages resulting from its breach of its fiduciary obligation and for an accounting. Also, Petitioner seeks authorization to object to a proof of claim filed by the Indenture Trustee on its own behalf (more fully described in paragraph 6 herein) and to assert a counterclaim thereto.

4. The Indenture, dated as of June 1, 1954, between the Debtor and the Indenture Trustee, provided for the issuance of the Debtor's Debentures in an aggregate principal amount of $8,607,600, such Debentures to be designated as "5% Sinking Fund Debentures due June 1, 1974." The Indenture was entered into in accordance with the Trust Indenture Act of 1939. Among other things, it provided for the form, issue, registration and redemption of the Debentures and contained covenants and duties and responsibilities of the Debtor and Indenture Trustee.

5. As at May 7, 1965, the date the Chapter X petition was filed, the principal amount of Debentures outstanding was $4,298,200, the reduced amount resulting from sinking fund payments made annually for the years 1955 through 1964, and the retirement of Debentures. Interest was paid semi-annually on the Debentures from December 1955 through December 1964.

6. On June 15, 1966 a proof of claim was filed in these proceedings by the Indenture Trustee on behalf of the Debentureholders in the amount of $4,298,200, representing principal and accrued interest from December 1, 1964. In addition, the Indenture Trustee filed a proof of claim on its

own behalf claiming that $51,447.55 was due to it for services rendered, disbursements made and expenses incurred by it as Indenture Trustee, prior to the filing of the Chapter X petition including some expenses attributable to the preparation and filing of the Chapter X petition and conferences relating thereto.

7. Among the covenants made by the Debtor in the Indenture are the following, all of which are set forth in Article III:

> A provision that the Debtor will punctually pay the principal and interest to become due in respect of all Debentures according to their terms. (Section 3.1)
>
> A provision forbidding the Debtor to incur or assume indebtedness from money borrowed or to purchase any real property or interests in real property unless its consolidated tangible assets as defined in the Indenture equal 200% of its remaining liabilities as defined therein. (Section 3.6)
>
> A requirement that the Debtor file with the Indenture Trustee within 120 days after the close of each fiscal year an officers' certificate stating that in the course of the performance by the signers of their duties as officers of the Debtor they would normally obtain knowledge of any default by the Company in performance or fulfillment of any covenant, agreement or condition contained in the Indenture, and stating whether or not they had obtained knowledge of any such default, and, if so, specifying each such default of which the signers had knowledge and the nature of such default. (Section 3.11)

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8. Included among the defaults as defined in Section 6.1 of Article VI of the Indenture were (a) failure to pay the principal of any of the Debentures when and as the same shall become due and payable, (b) failure to pay any installment of interest on any of the Debentures when and as the same shall become due and payable, (c) failure to pay any installment of the sinking fund when and as the same shall become due and payable, (d) failure to perform or observe any other of the covenants, conditions or agreements on the part of the Debtor contained in the Indenture if such failure continued for a period of 60 days after written notice to the Debtor from the Indenture Trustee and (e) acceleration of any indebtedness of the Debtor in the event of a default as defined in any mortgage, indenture or instrument executed by the Debtor.

9. During the period from January 1, 1959 to May 7, 1965 the Debtor entered into hundreds of loan and purchase transactions, involving tens of millions of dollars despite the fact that during all or most of that period the Debtor failed to maintain the ratio required by Section 3.6 of the Indenture which was designed and intended to assure sufficient asset coverage to protect the interest of the Debentureholders.

10. Commencing in 1955 and continuing through 1964, the officers of the Debtor in each year prepared and Debtor's directors unanimously (except for one director in 1963) approved appraisals which were submitted to the Indenture Trustee valuing the property of the Debtor for the purpose of satisfying the Indenture Trustee of its compliance with Section 3.6 of the Indenture. Such officers' appraisals contained grossly over-stated valuations of real estate owned by the Debtor, Investments made by the Debtor in subsidiaries, receivables from subsidiaries and other assets.

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11. In each of the years commencing in 1955 and continuing through 1964, the Debtor delivered to the Indenture Trustee copies of the officers' appraisals for the previous calendar year with a certificate stating that the Debtor had complied with the required ratio. The following is a table showing the ratios for the calendar years 1959 through 1963.

Year	Percent of Defined Assets to Defined Liabilities
1959	201.35
1960	216.88
1961	258.30
1962	206.90
1963	200.56

12. The Indenture Trustee accepted the appraisals submitted to it by the officers of the Debtor without questioning their accuracy and reliability. Furthermore, the Indenture Trustee knew or should have known that the standard used by the directors in appraising the assets of the Debtor was inconsistent with the protection intended by the Indenture.

13. Thus an examination of the appraisal submitted to the Indenture Trustee in July, 1959 for the year ended December 31, 1958 indicates an aggregate valuation of $372,000,000 for the consolidated tangible assets as opposed to a gross book value of those assets of only $245,000,000 an increase of $127,000,000. Despite this enormous inflation of book value the resulting ratio of assets to liabilities was only 202.61%. In other words a reduction of slightly more than $8,000,000 of appraised asset value would have resulted in a ratio of less than 200%.

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14. The significance of these figures is highlighted when reference is made to certain items representing a very substantial percentage of the total. Thus certain unimproved land in the Bronx which had a book value of only $2,900,000 was appraised at $27,500,000 for 1958 despite the fact that for the prior year, the same land had been appraised for $15,000,000. Other vacant land located in Los Angeles, California which had a book value of $2,200,000 was valued at $11,500,000 for 1958 although it had been valued at $7,000,000 for the prior year. Thus these two real estate investments comprising vacant land in Bronx, New York and in California were valued at $34,000,000 in excess of their book value and at $17,000,000 more than they had been valued the year before.

15. The situation in subsequent years followed an identical pattern except that the appraisals were even more greatly exaggerated. Some comparable figures for the subsequent years are as follows:

For the Year Ended 12/31	Aggregate Book of Consolidated Assets	Officers Appraised Value of Consolidated Assets	Asset Liability Ratio per Officers Appraisals	Excess of Officers Appraised Value Over Book Value
1959	$311,647,085	$487,638,449	201.35	$175,991,364
1960	283,960,356	453,038,688	216.88	169,078,332
1961	141,847,898	202,732,589	218.30	60,884,691
1962	168,383,618	257,406,151	206.90	89,022,493
1963	142,852,889	234,746,003	200.56	91,893,114

16. While the officers of the Debtor found it necessary to strain considerably to give the appearance of meeting the required ratio for the year ended December 31, 1958, their

attempts in subsequent years to give the appearance of compliance with the covenant in the Indenture exceeded all bounds in their flagrancy. For example, after having increased in 1958 from $15,000,000 to $27,000,000 the appraised value of the vacant land in the Bronx, this land was valued in 1959 at $64,000,000 an increase of $37,000,000. The only changes in circumstances on which any increase in valuation could have been based were the addition of land at a cost of $1,200,000 to the parcel and the execution of a lease to Freedomland, Inc. at an annual net rental of $600,000 with increases in subsequent years. These changes could in no way justify the astronomic increase in valuation.

17. In 1963 when the Debtor's problem of complying with the 2-1 ratio requirement became unsually acute, the officers without a murmur of dissent from the Indenture Trustee increased the appraisal from $64,000,000 to $91,000,000 although the Debtor then had less than an 80% interest in this property. In December, 1963 the property was conveyed to a corporation in which the Debtor only owned 80% of the stock. However, its interest was substantially watered down by virtue of other obligations connected with the conveyance. Moreover, as of the date of the submission of the appraisals, the Debtor's interest had been forfeited subject to an option to re-acquire at substantial cost to the Debtor and negotiations were virtually completed for the sale of two-thirds of the property for $15,000,000. All of the facts with respect to the Debtor's interest in this property were known, or would have been known to the Indenture Trustee if it had taken the trouble to examine the Debtor's Annual Report which had been provided to it in August of that year, two months prior to the receipt of the appraisal.

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18. Similarly, the officers grossly overvalued the Debtor's interest in Zeckendorf Properties Corporation ("ZPC"), a subsidiary, 50% of the stock of which was owned by the Debtor. That subsidiary was organized in 1961 at which time the Debtor transferred to it 13 undeveloped or partially developed urban renewal projects, including a substantial part of the Baychester property. Although the interest in ZPC was appraised by the officers at $15,000,000 for the year ended December 31, 1961, when necessity dictated, that appraisal was increased to $50,000,000 for the year ended December 31, 1962, despite the fact that in 1962 the subsidiary experienced serious financial difficulties, and despite the fact that by the time the appraisel for the year ended December 31, 1962 was actually filed with the Indenture Trustee, the interest of the Debtor in ZPC had been redeemed with W & K receiving for its interest five of the thirteen projects having an equity value of considerably less than $50,000,000.

19. The gross exaggerations of property values described with regard to the Baychester property and ZPC were by no means unique. A similar pattern was followed with regard to other properties owned by the Debtor in each of the years from 1958 through 1963. Thus, for example, in 1958 the Debtor owned property in the Lincoln Square area of New York City which in 1958 had a book value of $7,000,000 and which was appraised by officers of the Debtor for $12,000,000. In the following year, 1959, although the property had an increase in book value of only $2,400,000, the officers raised the appraisal on that property by $5,300,000. The pattern was repeated again in the following year when a raise in book value of $3,600,000 was seen by the officers as justification for raising the

appraisal by $8,100,000. Thus, over a period of three years an increase in book value of $6,000,000 was purportedly the basis for an increase in appraised value of $13,400,000.

20. Possibly the most significant aspect of these appraisals was the fact that after two years of experience gained in 1956 and 1957, the officers concluded that appraisals based on current values would not be adequate to satisfy the requirements of the Indenture. Accordingly, they adopted an approach to the appraisals based more on a Pollyanna-like hope for the future than on the realities of the present. Moreover, they made no attempt to hide the standards which they used to guide them, if they can be called standards, when they appended to each appraisal a footnote stating that the appraisals represented their "views as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established, . . .". In this connection it is interesting to note that William Zeckendorf, Sr., the Debtor's chief executive, when interrogated by Trustee's counsel, stated, with respect to the Baychester properties, that he anticipated that it would be approximately 1970 before the values which he attributed to that property in 1963 would be realized and then only after the expenditure of several hundred million dollars for improvements.

21. Unfortunately, this blatant disregard for reality on the part of the officers was met by an equally blatant lack of concern on the part of the Indenture Trustee. As appears from the testimony of the trust officer responsible for supervising the Debtor's compliance with the covenants of the Indenture, the Indenture Trustee made no attempt to establish any standards for judging the adequacy of the ap-

praisals, made no attempt to ascertain the standards used by the officers in preparing the appraisals and did not even attach significance to the footnote quoted above. A reading of the testimony makes it apparent that the Indenture Trustee considered its only obligation to be to insist upon an appraisal by the officers in a form acceptable to its accountants indicating the existence of the proper ratio. Needless to say, during the intervals between the receipt of the annual officers' appraisal, the Indenture Trustee made no effort whatever to ascertain whether or not the appropriate ratio was being maintained.

22. It must be conceded that on one occasion during the 10-year history of the Indenture, the Indenture Trustee saw fit to question the gross inflation of the valuation of the Baychester properties, the increase from $27,000,000 to $64,000,000 as of December 31, 1959 which has been referred to earlier in this petition. However, their fears, if such they were, were easily allayed when they were furnished with appraisals by an independent appraiser selected by W & K which indicated that the properties were indeed worth what the officers said they were, provided, however, an 800-unit motel and high-rise apartment developments containing thousands of units were constructed, and the operations of the now defunct Freedomland which was due to open a year later were successful in accordance with the most optimistic projections.

23. It would appear from an examination of all of the appraisals that during virtually the entire period from December 31, 1958 to the filing of the petition herein on May 7, 1965, the Debtor was in default of its covenant to refrain from borrowing monies or purchasing interests in real property when its asset-liability ratio was insufficient in accordance with the requirements of Section 3.6.

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24. As a result, during virtually the entire period of its stewardship, the Indenture Trustee failed to insure for its debentureholders the critical protection provided by the asset-liability ratio requirement of Section 3.6 and permitted the continuous depletion of the equity of the Debtor. For all intents and purposes the Indenture Trustee, by the virtual abdication of its duties, effectively nullified the provisions of Section 3.6 of the Indenture.

25. Such conduct on the part of an Indenture Trustee would be sufficiently reprehensible under the best of circumstances. Such conduct in the light of the poor and constantly deteriorating financial condition of the Debtor can most charitably be characterized as gross negligence. Commencing in 1958 W & K sustained substantial financial losses in every year but one and even in that year its income of approximately $2,500,000 was made possible only by a substantial write-up in value of the Baychester property contributed to ZPC. Without this write-up the company would have sustained a loss of approximately $6,000,000 for that year. The following is a table showing the taxable income and bookkeeping income of the Debtor during the years 1958 through 1963, the year of its last audited report. It is particularly significant that the Debtor's auditors accompanied their last audit with a statement that there was a question as to whether or not the Debtor could be treated as a going concern for purposes of valuing its assets and, accordingly, since they were not in a position to determine the realizable values of the assets they were unable to express an opinion on the financial statement as a whole.

Petition for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim against, and to Compel an Accounting by Marine Midland Grace Trust Company of New York

Year	Taxable Income	Bookkeeping Income
1958	($9,242,761.31)	($6,380,926.00)
1959	(21,190.20)	(1,026,484.00)
1960	(873,643.10)	(6,073,798.00)
1961	(4,916,087.76)	2,462,700.00 [1]
1962	(8,781,589.68)	(19,625,151.00)
1963	(11,156,793.80)	(32,320,953.00)

[1] Includes book profit of $8,995,530.00 on sale on December 19, 1961 to 91273 Corp., a wholly owned subsidiary of Zeckendorf Property Corp., 50% of whose stock being owned by Webb & Knapp, Inc.

26. Armed with the knoweldege readily available to it of the Debtor's financial straits, the failure of the Indenture Trustee to scrutinize the officers' appraisals which purported to reflect compliance only by the smallest margins and then after violent adjustments of prior appraised values, was even more egregious.

27. During the years 1962, 1963 and 1964, the Debtor was guilty of numerous other defaults in the performance of its obligations under the Indenture, each of which should have served to alert the Indenture Trustee to the increasing threat of financial disaster and resulting loss to the debenture holders. Thus, in 1962, the Debtor failed to file its officers' appraisal until August, four months after it was due. Similarly, in 1963, the Debtor was three months late in filing both the officers' certificate of no default and the officers' appraisal. In 1964, the Debtor was late in making the sinking-fund payment due on May 25, 1964 and the semi-annual interest installments due on June 1, 1964. These payments were not made until July 30, 1964 after the Indenture Trustee gave notice to the debentureholders of the fact of default. In addition, during 1964 the officers'

appraisal which was due on April 30 was not filed until some time in October. Also during 1964, maturity dates of certain indebtedness of the Debtor was accelerated because of the Debtor's default in making payments on account of such indebtedness. Such accelerations constituted defaults under the Indenture. Moreover, in 1964 several creditors entered judgments against the Debtor in substantial amounts to the knowledge of the Indenture Trustee. In August of that year, two wholly-owned subsidiaries filed petitions for arrangement pursuant to Chapter XI of the Bankruptcy Act and in the same year a third subsidiary was the subject of an involuntary bankruptcy proceeding.

28. Despite all of these circumstances, the Debtor was permitted during the entire period from 1959 to 1965 to continuously deplete its equity by incurring new obligations and acquiring highly speculative interests in real property with the final result that by the time of the filing of the petition on May 7, 1965 by the Indenture Trustee, the stockholders' equity, which on the basis of officers' appraisal was $214,000,000 for the year ended December 31, 1959 and $84,000,000 for the year ended December 31, 1963 was reduced to a deficit of $38,000,000.

29. When this drastic reduction in equity is considered along with the fact of losses of $70,000,000 during the years 1958 through 1963, the impact on the interest of the debentureholders by the gross negligence of the Indenture Trustee is staggering.

30. In view of all of the foregoing, your petitioner requests permission of this Court to commence action against the Indenture Trustee for the recovery of the damages sustained by virtue of the grossly negligent performance of its fiduciary obligations. Your petitioner seeks to assert this

Petition for an Order Authorizing the Trustee to Commence an Action or Assert a Counterclaim against, and to Compel an Accounting by Marine Midland Grace Trust Company of New York

claim in the form of both an independent plenary action and by means of a counterclaim to the Indenture Trustee's proof of claim on behalf of itself. In addition, your petitioner requests that this Court order and direct the Indenture Trustee forthwith to file an accounting of its activities as Indenture Trustee from the date of the commencement of the Trust to the present.

Dated: Washington, D. C.
April 12, 1967

MORTIMER M. CAPLIN
Mortimer M. Caplin, Petitioner
MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER
Counsel for the Trustee
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421-7200

(Verified April 12, 1965)

Complaint in 67 Civ. 1914, *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York*

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 1914

PLAINTIFF DEMANDS A JURY TRIAL

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant.

Plaintiff, MORTIMER M. CAPLIN, trustee in reorganization of Webb & Knapp, Inc., by his attorneys, Marshall, Bratter, Greene, Allison & Tucker, as and for his complaint herein, respectfully alleges:

AS AND FOR A FIRST CLAIM FOR RELIEF

1. Plaintiff is the trustee of Webb & Knapp, Inc. (hereinafter referred to as the "Debtor"), a Debtor in reorganization pursuant to Chapter X of the Bankruptcy Act, in proceedings in the United States District Court for the Southern District of New York.

Complaint in 67 Civ. 1914, Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York

2. The defendant, The Marine Midland Grace Trust Company of New York (hereinafter referred to as "Marine") is a banking corporation, organized and existing under the laws of the State of New York having its principal place of business in the Southern District of New York. Upon information and belief it is the successor to and has assumed all of the obligations and liabilities of the Marine Midland Trust Co.

3. Jurisdiction of this Court is based on Section 2a of the Bankruptcy Act, 11 U. S. C. § 11a.

4. By order of the United States District Court for the Southern District of New York dated May 18, 1965, plaintiff became vested with title to all property of the Debtor of whatever kind and wherever located and became vested with all the rights, powers, and duties of a trustee appointed under Chapter X, and, to the extent not inconsistent with Chapter X, of a trustee appointed under Section 44 of the Bankruptcy Act, and also was granted such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the Debtor.

5. For many years prior to the filing of the petition for reorganization, the Debtor was in the business, among other things, of owning, constructing, improving, leasing, operating and managing interests in real estate and acting as broker in connection with the sale, purchase or lease of interests in real estate or the arranging of financing for such sales, purchases or leases.

6. On or about June 1, 1954, the Debtor and Marine as trustee, executed a certain Trust Indenture (hereinafter referred to as the "Indenture") providing for the issuance by the Debtor of 5% Sinking Fund Debentures due June,

1974 in the aggregate principal amount of $8,607,600. Debentures in the total principal amount of $4,298,200 are now outstanding. A copy of said Indenture is annexed hereto as Exhibit "A".

7. In the Indenture, the Debtor made certain covenants and agreements to and with Marine as trustee for the use and benefit of all holders of the debentures to be issued under such Indenture, and Marine undertook in Section 10.1 thereof to perform the duties set forth in the Indenture and to use the same degree of care and skill in the exercise of the rights and powers vested in it as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

8. The Indenture in Section 3.6 prohibited the Debtor or its consolidated subsidiaries from incurring or assuming any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property on which the Debtor was personally liable, or from purchasing any real property or interests in real property, unless at a date not more than four months prior to such transaction, the Debtor's consolidated tangible assets as defined in the Indenture equalled 200% of the Debtor's liabilities, as defined in the Indenture, after giving effect to the contemplated loan or purchase.

9. The Indenture also contained a covenant in Section 3.11 thereof that the Debtor would file with the defendant, within 120 days after the close of the fiscal year ending December 31, 1954, and within 120 days after the close of each fiscal year thereafter, an officer's certificate stating that in the course of the performance of their duties the officers would normally obtain knowledge of any default by the company in the performance or fulfillment of any covenant, agreement or condition of the Indenture and stat-

ing whether or not they have obtained knowledge of any such default, and, if so, specifying each such default of which the officers have knowledge and the nature thereof.

10. At the time of the issuance of the Debtor's debentures, substantially all of the tangible assets of the Debtor consisted of investments in purchase money mortgages, stock in and receivables from subsidiary corporations, and investments in real estate.

11. During the period from December 31, 1958 through May 7, 1965, the Debtor sustained substantial operating losses and its obligations greatly increased. An apparent profit in 1961 was the result of a revaluation of certain assets in conjunction with their being transferred to a newly formed fifty percent-owned subsidiary.

12. In each of the years 1954 through 1964, the officers of the Debtor at the request of Marine prepared, and the Debtor's directors approved, appraisals of the Debtor's assets containing grossly overstated valuations of certain properties owned by the Debtor for the purpose of satisfying Marine that it was not in violation of the covenant contained in Section 3.6 of the Indenture requiring the Debtor to maintain a two to one ratio of assets to liabilities. These appraisals were prepared and delivered to Marine only once in each year.

13. The appraisals delivered during the years 1958 through 1964 each contained as a footnote the statement that the appraisal represented the officers' "views as to what the properties could be sold for on a cash basis under favorable market conditions, after their earning power shall have been clearly established".

14. The appraisals delivered to Marine as aforesaid were false and fraudulent and in fact at no time during the

period 1958 through 1964 were the Debtor's consolidated tangible assets equal to 200% of its liabilities as required by Section 3.6 of the Indenture. On the contrary, at all times the ratio of consolidated tangible assets to liabilities was substantially less than two to one.

15. Marine at all times knew, or in the exercise of reasonable diligence, should have known that the officers' appraisals were falsely and fraudulently inflated and that the ratio of the Debtor's consolidated tangible assets to its liabilities was such that any borrowings or purchases by the Debtor would and did constitute violations of the Debtor's covenants as set forth in Section 3.6 of the Indenture.

16. Marine at all times knew or should have known that the Debtor was suffering serious financial losses.

17. During the years 1959 through 1965 the Debtor incurred additional indebtedness and purchased additional property despite the fact that Section 3.6 of the Indenture prohibited such borrowing and such purchases unless the required ratio of consolidated tangible assets to liabilities was maintained.

18. It was the obligation of Marine to protect the debentureholders by taking the necessary steps to prevent the Debtor from borrowing any money or purchasing any property during any of the years 1959 through 1975 since any such borrowings or purchases were specifically prohibited by Section 3.6 of the Indenture.

19. The failure of Marine to take appropriate steps to prevent the borrowing of funds or the purchases of property by the Debtor enabled the Debtor to enter into countless transactions in violation of the covenant contained in Section 3.6 of the Indenture with resultant loss and diminu-

tion of assets of the Debtor which caused the net worth of the Debtor to be reduced from $25,066,657 as of December 31, 1958 to a deficit of $38,5[illegible],000 at the time of the filing of the petition in these proceedings.

20. Marine's failure to ascertain that the Debtor was in violation of its obligations pursuant to the provisions of Section 3.6 of the Indenture and its failure to take appropriate steps to protect the debentureholders as aforesaid either constituted willful misconduct or gross negligence in violation of its obligations as Indenture Trustee.

21. By reason of the foregoing, the holders of the Debtor's debentures under the Indenture have suffered damage in the amount of $4,298,200.

WHEREFORE, plaintiff, on behalf of holders of the outstanding debentures issued under the Indenture, demands judgment against Marine in the sum of $4,298,200 together with interest according to law and the costs and disbursements of this action.

Dated: New York, New York
May 15, 1967

MARSHALL, BRATTER, GREENE, ALLISON & TUCKER

By s/ MORTON S. ROBSON
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A Member of the Firm

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Objection by the Trustee to Allowance of Claim and Counterclaim of Trustee

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
No. 65-B-365

In Proceedings for the Reorganization of Corporations pursuant to Chapter X of the Bankruptcy Act

In the Matter

of

WEBB & KNAPP, INC., and Subsidiaries,

Debtors.

TO: THE HONORABLE EDWARD C. MCLEAN, JUDGE OF THE UNITED STATES DISTRICT COURT OF THE SOUTHERN DISTRICT OF NEW YORK

MORTIMER M. CAPLAN, Trustee of the Debtors, objects to the allowance of the claim of Marine Midland Grace Trust Company of New York ("Marine"), filed herein in the amount of $51,447.55 and asserts a counterclaim against Marine upon the following grounds:

1. On or about June 1, 1954, the Debtor and Marine as trustee, executed a certain Trust Indenture (hereinafter referred to as the "Indenture") providing for the issuance by the Debtor of 5% Sinking Fund Debentures due June, 1974 in the aggregate principal amount of $8,607,600. Debentures in the total principal amount of $4,298,200 are now outstanding.

2. In the Indenture, the Debtor made certain covenants and agreements to and with Marine as trustee for the use

and benefit of all holders of the debentures to be issued under such Indenture, and Marine undertook in Section 10.1 thereof to perform the duties set forth in the Indenture and to use the same degree of care and skill in the exercise of the rights and powers vested in it as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

3. The Indenture in Section 3.6 prohibited the Debtor or its consolidated subsidiaries from incurring or assuming any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property on which the Debtor was personally liable, or from purchasing any real property or interests in real property, unless at a date not more than four months prior to such transaction, the Debtor's consolidated tangible assets as defined in the Indenture equalled 200% of the Debtor's liabilities, as defined in the Indenture, after giving effect to the contemplated loan or purchase.

4. The Indenture also contained a covenant in Section 3.11 thereof that the Debtor would file with the defendant, within 120 days after the close of the fiscal year ending December 31, 1954, and within 120 days after the close of each fiscal year thereafter, an officer's certificate stating that in the course of the performance of their duties the officers would normally obtain knowledge of any default by the company in the performance or fulfillment of any covenant, agreement or condition of the Indenture and stating whether or not they have obtained knowledge of any such default, and, if so, specifying each such default of which the officers have knowledge and the nature thereof.

5. At the time of the issuance of the Debtor's debentures, substantially all of the tangible assets of the Debtor consisted of investments in purchase money mortgages, stock in and receivables from subsidiary corporations, and investments in real estate.

Objection by the Trustee to Allowance of Claim and Counterclaim of Trustee

6. During the period from December 31, 1958 through May 7, 1965, the Debtor sustained substantial operating losses and its obligations greatly increased. An apparent profit in 1961 was the result of a revaluation of certain assets in conjunction with their being transferred to a newly formed fifty percent-owned subsidiary.

7. In each of the years 1954 through 1964, the officers of the Debtor at the request of Marine prepared, and the Debtor's directors approved, appraisals of the Debtor's assets containing grossly overstated valuations of certain properties owned by the Debtor for the purpose of satisfying Marine that it was not in violation of the covenant contained in Section 3.6 of the Indenture requiring the Debtor to maintain a two-to-one ratio of assets to liabilities. These appraisals were prepared and delivered to Marine only once in each year.

8. The appraisals delivered during the years 1958 through 1964 each contained as a footnote the statement that the appraisal represented the officers' "views as to what the properties could be sold for on a cash basis under favorable market conditions, after their earning power shall have been clearly established".

9. The appraisals delivered to Marine as aforesaid were false and fraudulent and in fact at no time during the period 1958 through 1964 were the Debtor's consolidated tangible assets equal to 200% of its liabilities as required by Section 3.6 of the Indenture. On the contrary, at all times the ratio of consolidated tangible assets to liabilities was substantially less than two to one.

10. Marine at all times knew, or in the exercise of reasonable diligence, should have known that the officers' appraisals were falsely and fraudulently inflated and that the ratio of the Debtor's consolidated tangible assets to

its liabilities was such that any borrowings or purchases by the Debtor would and did constitute violations of the Debtor's covenants as set forth in Section 3.6 of the Indenture.

11. Marine at all times knew or should have known that the Debtor was suffering serious financial losses.

12. During the years 1959 through 1965 the Debtor incurred additional indebtedness and purchased additional property despite the fact that Section 3.6 of the Indenture prohibited such borrowing and such purchases unless the required ratio of consolidated tangible assets to liabilities was maintained.

13. It was the obligation of Marine to protect the debentureholders by taking the necessary steps to prevent the Debtor from borrowing any money or purchasing any property during any of the years 1959 through 1965 since any such borrowings or purchases were specifically prohibited by Section 3.6 of the Indenture.

14. The failure of Marine to take appropriate steps to prevent the borrowing of funds or the purchase of property by the Debtor enabled the Debtor to enter into countless transactions in violation of the covenant contained in Section 3.6 of the Indenture with resultant loss and diminution of assets of the Debtor which caused the net worth of the Debtor to be reduced from $25,066,657 as of December 31, 1958 to a deficit of $38,500,000 at the time of the filing of the petition in these proceedings.

15. Marine's failure to ascertain that the Debtor was in violation of its obligations pursuant to the provisions of Section 3.6 of the Indenture and its failure to take appropriate steps to protect the debentureholders as aforesaid either constituted willful misconduct or gross negligence in violation of its obligations as Indenture Trustee.

Objection by the Trustee to Allowance of Claim and Counterclaim of Trustee

16. By reason of Marine's willful misconduct or gross negligence as herein set forth, Marine should be denied compensation as Indenture Trustee.

AS AND FOR A FIRST COUNTERCLAIM

17. The Trustee repeats and re-alleges paragraphs 1 through 15 set forth herein.

18. By reason of the foregoing, the holders of the Debtor's debentures under the Indenture have suffered damage in the amount of $4,298,200.

WHEREFORE, the Trustee demands judgment against Marine disallowing the claim made by Marine, and on behalf of holders of the outstanding debentures issued under the Indenture demands judgment against Marine in the sum of $4,298,200 together with interest according to law and the costs and disbursements of this action.

Dated: New York, New York
May 16, 1967

MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER
By S/ MORTON S. ROBSON
Morton S. Robson
A Member of the Firm
Attorneys for Plaintiff
430 Park Avenue
New York, New York 10022

Notice of Motion by Defendant in 67 Civ. 1914, *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York*, to dismiss the Complaint

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 1914

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant.

SIRS:

PLEASE TAKE NOTICE that upon all of the papers and proceedings herein, the undersigned will move before The Honorable Edward C. McLean in Room 2704 in the United States Court House, Foley Square, New York, New York, on the 4th day of December, 1967, at 10:00 o'clock in the forenoon of that day or as soon thereafter as counsel can be heard, for

(1) An order pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure dismissing the complaint herein for failure to state a claim upon which relief can be granted

Notice of Motion by Defendant in 67 Civ. 1914, Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York, to dismiss the Complaint

because plaintiff has no standing to assert against defendant the claim set forth in the complaint, or, alternatively,

(2) An order pursuant to Rule 17(a) of the Federal Rules of Civil Procedure dismissing the complaint because it is not prosecuted in the name of the real parties interest, and

(3) Such other relief as the Court may deem just and proper.

Dated: New York, New York
November 22, 1967

Yours, etc.

SULLIVAN & CROMWELL
By JOHN DICKEY
(A member of the Firm)
Attorneys for Defendant,
48 Wall Street,
New York, New York 10005

To:

MESSRS. MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER,
Attorneys for Plaintiff,
430 Park Avenue,
New York, New York 10022

Notice of Motion by Marine Midland Grace Trust Company of New York to Dismiss the Counterclaim of the Trustee and Strike the Objection to Allowance of the Proof of Claim of Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC., *et al.*,

Debtors.

SIRS:

PLEASE TAKE NOTICE that upon the Objection by Trustee to Allowance of Claim and Counterclaim, dated May 15, 1967, filed herein by the Trustee in reorganization of the Debtors herein, and upon the proof of claim dated June 14, 1966, filed herein by Marine Midland Grace Trust Company of New York ("Marine Midland") for its own account, the undersigned will move before The Honorable Edward C. McLean in Room 2704 of the United States Court House, Foley Square, New York, New York on the 4th day of December, 1967, at 10:00 o'clock in the forenoon of that day or as soon thereafter as counsel can be heard, for

(1) An order pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure dismissing the counterclaim asserted in the Trustee's pleading for failure to state a claim upon which relief can be granted because the Trustee has

Notice of Motion by Marine Midland Grace Trust Company of New York to dismiss the Counterclaim of the Trustee and strike the objection to allowance of the proof of claim of Marine Midland Grace Trust Company of New York

no standing to assert against Marine Midland the claim set forth in the counterclaim, or, alternatively,

(2) An order pursuant to Rule 12(b)(1) of the Federal Rules of Civil Procedure dismissing the counterclaim because there is no summary jurisdiction over the subject matter of the counterclaim, or, alternatively,

(3) An order pursuant to Rule 17(a) of the Federal Rules of Civil Procedure dismissing the counterclaim because it is not prosecuted in the name of the real parties in interest, and

(4) An order pursuant to Rule 12(f) of the Federal Rules of Civil Procedure striking the objection asserted in the Trustee's pleading as constituting an insufficient defense to Marine Midland's proof of claim, and

(5) Such other relief as the Court may deem just and proper.

Dated: New York, New York
November 22, 1967

Yours, etc.,

SULLIVAN & CROMWELL
By JOHN DICKEY
(A Member of the Firm)
Attorneys for Marine Midland
Grace Trust Company of
New York,
40 Wall Street,
New York, New York 10005

To: [All parties on which the counterclaim was served by the Chapter X Trustee]

Opinion and Order of District Court Filed May 20, 1968, Granting Defendant's Motion to Dismiss the Complaint in 67 Civ. 1914, *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York*

#34809.
U. S. District Court
Filed
May 20, 1968
4:40 P.M.
S. D. of N. Y.

UNITED STATES DISTRICT COURT

SOUTHERN DISTORICT OF NEW YORK

Opinion in 67 Civ. 1914

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant.

McLEAN, *D.J.*

Defendant has moved pursuant to Rules 12(b)(6) and 17(a) to dismiss this action on the grounds that the complaint fails to state a claim and that plaintiff is not the real party in interest.

Opinion and Order of District Court Filed May 20, 1968, Granting Defendant's Motion to Dismiss the Complaint in 67 Civ. 1914; Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York

The complaint may be briefly summarized as follows: Plaintiff is the trustee of Webb & Knapp, Inc. (the Debtor), now in reorganization under Chapter X of the Bankruptcy Act. Defendant is trustee under a trust indenture executed by the Debtor with respect to an issue of 5 per cent debentures of the Debtor due in June 1974. Debentures in the principal amount of $4,298,200 are now outstanding. In the indenture the debtor made certain covenants "for the use and benefit of all holders of the debentures." One of these provided that the Debtor would not incur certain types of indebtedness unless its tangible assets were twice its liabilities. Prior to the Debtor's bankruptcy, defendant, as indenture trustee, failed to enforce this covenant. Defendant accepted appraisals of the Debtor's property, delivered to it by the Debtor, which were false and fraudulent and which defendant knew or in the exercise of due diligence should have known were false and fraudulent. Defendant failed to prevent the Debtor from incurring additional indebtedness despite the fact that the Debtor's assets were not twice its liabilities. As a result, the debenture holders have been damaged in the sum of $4,298,200 (the full face amount of the outstanding debentures). Plaintiff, "on behalf of" the debenture holders, seeks judgment in that amount.

The question is whether plaintiff, the Debtor's reorganization trustee, has standing to maintain this action on behalf of the debenture holders. *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), which is squarely in point, answers this question in the negative. The Court of Appeals there held that such a

Opinion and Order of District Court Filed May 20, 1968, Granting Defendant's Motion to Dismiss the Complaint in 67 Civ. 1914, Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York

claim against an indenture trustee for failure to enforce a negative covenant made by the Debtor was a claim that is "personal to" the debenture holder. It held that the reorganization trustee had no title to the claim and could not maintain an action on it on behalf of the debenture holders. The order of the district court dismissing the action was affirmed, on the ground that the complaint did not state a claim and that the reorganization trustee was not the real party in interest.

This decision appears to be still the law in this circuit. I do not agree with plaintiff's contention that *Clarke* was overruled, *sub silentio*, by *Prudence-Bonds Corp.* v. *States Street Trust Co.*, 202 F. 2d 555 (2d Cir. 1953).

Plaintiff relies on *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953), which reached a contrary result. The court in *Solar* purported to distinguish *Clarke* on the ground that in *Clarke* the reorganization trustee had asserted the claim in a plenary action (as he does in the present case), whereas in *Solar*, the claim was asserted by the reorganization trustee by way of a counterclaim to an account filed by the indenture trustee of its doings as such indenture trustee and to a proof of claim filed by the indenture trustee for its services.

In my opinion, the difference in the form of the proceeding does not require or permit a difference in result on the substantive issue of the standing of the reorganization trustee to seek affirmative relief. Unless the factual situation in *Solar* can be said to be sufficiently different from that in *Clarke* to justify a distinction between the two cases

Opinion and Order of District Court Filed May 20, 1968, Granting Defendant's Motion to Dismiss the Complaint in 67 Civ. 1914, Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York

on the merits, then the decisions in *Solar* and *Clarke* are in conflict.

Defendant argues that there is such a factual difference. This seems to me improbable, but it is unnecessary to decide that question. There is no distinction between *Clarke* and the present case, and if it be assumed that *Clarke* and *Solar* are conflicting, then it is the clear duty of this court to follow *Clarke* as the controlling decision in this circuit.

Plaintiff's contention that *Clarke* is wrong and that the dissenting opinion in that case presents the correct view is an argument which is not open to plaintiff in this court. Similarly, plaintiff's arguments based on matters of policy and upon the legislative history of the Bankruptcy Act are arguments which can properly be made only to the Court of Appeals. Only the Court of Appeals can decide whether or not *Clarke* is to be overruled.

Defendant's motions are granted. The action is dismissed.

So ordered.

Dated: May 20, 1968

EDWARD C. McLEAN
U.S.D.J.

Opinion of District Court Filed May 20, 1968 Granting the Motion of Marine Midland Grace Trust Company of New York to Dismiss the Trustee's Counterclaim and Denying Marine Midland Grace Trust Company of New York's Motion to Strike the Trustee's Objection to the Proof of Claim

Paper #472
U. S. District Court
Filed
May 20, 1968
S. D. of N. Y.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 B 365

In the Matter

of

WEBB & KNAPP, INC., et al.,

Debtors.

MOTION OF MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK TO DISMISS THE OBJECTION AND COUNTERCLAIM OF THE DEBTOR'S TRUSTEE

McLEAN, *D. J.*

This motion by Marine Midland Grace Trust Company of New York (Marine Midland) involves the question which was presented by defendant's motion to dismiss the action entitled *Caplin, Trustee in Reorganization of Webb &*

Opinion of District Court Filed May 20, 1968 Granting the Motion of Marine Midland Grace Trust Company of New York to Dismiss the Trustee's Counterclaim and Denying Marine Midland Grace Trust Company of New York's Motion to Strike the Trustee's Objection to the Proof of Claim

Knapp, Inc., etc. v. *The Marine Midland Grace Trust Company of New York*, 67 Civ. 1914, a motion which I have granted by opinion filed today.

Caplin v. *Marine Midland* was a plenary action which the reorganization trustee of the debtor sought to maintain on behalf of debenture holders to recover damages which the debenture holder allegedly suffered by reason of the failure of Marine Midland, as indenture trustee, to enforce a negative covenant made by the debtor for the benefit of the debenture holders. The nature of this covenant is explained in the *Caplin* opinion. That explanation need not be repeated here.

In the present case the same question has been raised in the Chapter X reorganization proceeding of the debtor. Marine Midland filed a proof of claim in the Chapter X proceeding in the sum of $51,447.55 for compensation for its services as indenture trustee. The reorganization trustee of the debtor subsequently filed an "objection" to this claim. The reorganization trustee took the position that Marine Midland is not entitled to compensation as indentrue trustee because it failed to enforce the negative covenant. The allegations of this objection are substantially identical with those of the complaint in the *Caplin* action.

In addition, the reorganization trustee realleged all these allegations as a counterclaim "on behalf of the holders of the outstanding debentures" to recover damages in the sum of $4,298,200 which the debenture holders have allegedly suffered by reason of Marine Midland's failure to enforce the negative covenant.

Marine Midland now moves to dismiss the counterclaim on the same grounds upon which it moved to dismiss the

Opinion of District Court Filed May 20, 1968 Granting the Motion of Marine Midland Grace Trust Company of New York to Dismiss the Trustee's Counterclaim and Denying Marine Midland Grace Trust Company of New York's Motion to Strike the Trustee's Objection to the Proof of Claim

Caplin action, *ie.*, that the counterclaim fails to state a claim and that the reorganization trustee is not the real party in interest, plus the additional ground that the bankruptcy court does not have summary jurisdiction to determine the counterclaim. Marine Midland also moves to strike the objection on the ground that it is "an insufficient defense to Marine Midland's proof of claim."

The motion addressed to the counterclaim must be granted. As it pointed out in the court's opinion dismissing the *Caplin* action, *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), a decision binding upon this court, held that a reorganization trustee has no standing to maintain a plenary action on behalf of debenture holders to recover damages allegedly sustained by them by reason of the failure of an indenture trustee to enforce a negative covenant made by the debtor for the benefit of the debenture holders. It necessarily follows that the reorganization trustee has no standing to seek precisely the same affirmative relief, on the same grounds, by way of counterclaim. According to *Clarke*, it is the debenture holders, not the reorganization trustee, who own the claim and hence it is only the debenture holders who may sue on it. To the extent that *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert. denied*, 345 U. S. 940 (1953), drew a distinction between enforcing a claim by independent action and enforcing it by counterclaim, I do not feel at liberty to follow that decision.

In view of this conclusion it is unnecessary to consider the separate question as to whether the bankruptcy court has summary jurisdiction over the counterclaim.

Opinion of District Court Filed May 20, 1968 Granting the Motion of Marine Midland Grace Trust Company of New York to Dismiss the Trustee's Counterclaim and Denying Marine Midland Grace Trust Company of New York's Motion to Strike the Trustee's Objection to the Proof of Claim

The reorganization trustee's "objection," which in substance amounts to an alleged affirmative defense to Marine Midland's proof of claim, presents a different situation. In opposing Marine Midland's claim, the reorganization trustee is acting, not solely on behalf of the debenture holders, but on behalf of all persons interested in the estate. In this instance Marine Midland is not defending itself against a claim asserted against it on behalf of the debenture holders. It is seeking to recover money for itself. The services for which Marine Midland asks compensation were services rendered by it for the benefit of the debenture holders. Marine Midland's claim necessarily presupposes that it has fully performed its obligations to the debenture holders. If it has not, if it has failed to protect their interests in the manner required by the indenture, it would not be entitled to compensation from the debenture holders.

Marine Midland seeks to recover compensation in this instance from the estate, rather than from the debenture holders, because the indenture provides that the debtor will pay the trustee's compensation for its services. But if Marine Midland is not entitled to compensation from the debenture holders because of its nonperformance of its obligations, it follows that it cannot recover from the debtor either. Thus, Marine Midland's alleged nonperformance is a valid defense, on its face, to Marine Midland's claim.

Marine Midland is attempting to enforce its claim against the debtor's estate. The reorganization trustee, who represents the estate, has standing to resist the claim. If its resistance turns out to be successful, all persons interested in the estate, not merely the debenture holders, will benefit. *Clarke* does not apply in this situation.

Opinion of District Court Filed May 20, 1968 Granting the Motion of Marine Midland Grace Trust Company of New York to Dismiss the Trustee's Counterclaim and Denying Marine Midland Grace Trust Company of New York's Motion to Strike the Trustee's Objection to the Proof of Claim

There can be no question, nor does Marine Midland raise any, about the jurisdiction of the bankruptcy court to determine claims against the debtor's estate.

Marine Midland's motion to dismiss the reorganization trustee's counterclaim is granted. Its motion to strike the reorganization trustee's objection is denied.

Settle order on notice.

/s/ EDWARD C. McLEAN
U. S. D. J.

Dated: May 20, 1968

Opinion of District Court Filed May 22, 1968 Denying the Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

#34822
paper #474
U. S. District Court
filed
May 22, 1968
4:30 P. M.
S. D. of N. Y.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 B 365

IN THE MATTER

of

WEBB & KNAPP, INC., and subsidiaries,

Debtors.

APPLICATION OF THE TRUSTEE FOR AN ORDER COMPELLING MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK TO ACCOUNT FOR ITS ACTS AS INDENTURE TRUSTEE

McLEAN, D. J.

By order No. 100 dated April 27, 1967, this court granted the application of the trustee of the Debtor to begin a plenary action against Marine Midland Grace Trust Company of New York (Marine Midland), trustee under an indenture relating to 5 per cent debentures of the Debtor due June 1, 1974, to recover damages allegedly sustained by

Opinion of District Court Filed May 22, 1968 Denying the Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

the debenture holders by virtue of Marine Midland's failure to enforce a negative covenant contained in the indenture. The order also authorized the Debtor's trustee to assert the same claim against Marine Midland by way of counterclaim to the claim filed in the reorganization proceeding by Marine Midland for compensation for its services as indenture trustee. The court reserved decision upon a third application made by the Debtor's trustee at that time, an application to require Marine Midland to account to this court for its acts as indenture trustee.

Thereafter the Debtor's trustee began the plenary action, entitled *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp. Inc., etc.* v. *The Marine Midland Grace Trust Company of New York,* 67 Civ. 1914. The Debtor's trustee also asserted the same claim by setting up a counterclaim to the proof of claim for compensation filed by Marine Midland in the reorganization proceeding. Marine Midland moved to dismiss both the plenary action and the counterclaim. By opinions dated May 20, 1968, the court has granted those motions on the authority of *Clarke* v. *Chase National Bank of City of New York,* 137 F. 2d 797 (2d Cir. 1943). The court permitted the Debtor's trustee, however, to assert the claim as a defense to Marine Midland's claim for compensation.

This memorandum is devoted to the question as to which decision was previously reserved, *i.e.,* whether Marine Midland should now be required to account. Assuming that the court has power to make such a direction, the court sees no valid reason for exercising that power at this time.

Marine Midland is still acting as indenture trustee for the debenture holders. It has filed a proof of claim on their behalf in the reorganization proceeding. It has not

resigned, nor has it indicated any intention or desire to resign.

There is no claim here that Marine Midland has in any way mishandled any funds which have come into its hands as indenture trustee. The only claim which the Debtor's trustee has asserted against it is that in the years prior to the Debtor's bankruptcy, it failed to enforce the negative covenant in the indenture. It is apparent that the real reason why the Debtor's trustee requests that Marine Midland be required to account is the fact that the Debtor's trustee believes that he might have standing to assert this claim as a counterclaim to an account, even if he has no standing to assert it by a counterclaim to Marine Midland's claim for services or by independent action.

> *See In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3rd Cir. 1952), *cert. denied*, 345 U.S. 940 (1953).

This belief is not well founded, as long as *Clarke* continues to be the law in this circuit. Since the reorganization trustee has no title to the claim of the debenture holders for damages for the nonperformance by Marine Midland of its duty to enforce the negative covenant, the Debtor's trustee, under the *Clarke* rule, may not sue on that claim. It can make no difference that affirmative relief is sought by counterclaim rather than by independent action, or that the counterclaim is interposed to an account rather than to a claim for services. Hence to require an account from Marine Midland would not accomplish the purpose which the Debtor's trustee has in mind.

It is suggested that Marine Midland's personal interest is in conflict with the interest of the debenture holders. This amounts to a claim that Marine Midland should be

Opinion of District Court Filed May 22, 1968 Denying the Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

removed as indenture trustee, although no such relief is requested in the moving papers.

The suggestion of conflict of interest seems to the court to be far-fetched. Marine Midland initiated this Chapter X proceeding. It asserts that it has acted throughout in accordance with its obligations under the indenture. Obviously, there is no conflict between this position and its continued representation of the bondholders. And even if this court should eventually sustain the Debtor's trustee's objection to Marine Midland's claim for compensation on the ground that Marine Midland failed to enforce the negative covenant prior to the Debtor's bankruptcy, it does not necessarily follow that Marine Midland cannot properly represent the debenture holders in the reorganization proceeding. It would be unjust to remove Marine Midland merely because an objection has been made to its conduct prior to the bankruptcy, an objection which as yet has not been proved. The court sees no probability of injury to the bondholders by permitting Marine Midland to continue to represent them in the meantime, at least until that question is resolved.

Accordingly, the Debtor's trustee's motion to compel Marine Midland to account is denied.

Settle order on notice.

Dated: May 22, 1968

EDWARD MCLEAN

.....

U.S.D.J.

Order of District Court Filed June 7, 1969 Denying the Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

Filed
June 7, 1968

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Order No. 132, 65-B-365

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC., and subsidiaries,

Debtors.

MORTIMER M. CAPLIN, Trustee in Reorganization of the debtors, having moved for an order to compel an accounting by Marine Midland Grace Trust Company of New York, and said motion having come on regularly to be heard, and argument being had thereon, and the Court having made its decision in writing and due deliberation having been had, it is on motion of Sullivan & Cromwell, attorneys for Marine Midland Grace Trust Company of New York,

ORDERED, that the motion of the Trustee in Reorganization to compel Marine Midland Grace Trust Company of New York to account is denied.

Dated: New York, New York
June 7, 1968

EDWARD C. McLEAN
U.S.D.J.

Order of District Court Filed June 7, 1967 Granting Motion of Marine Midland Grace Trust Company of New York to Dismiss Counterclaim and Denying the Motion to Strike the Trustee's Objection to the Proof of Claim of Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Order No. 133, 65-B-365

Filed
June 7, 1968

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC., *et al.*,

Debtors.

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK having moved for an order pursuant to Rules 12(b)(6), 12(b)(1) and 17(a) of the Federal Rules of Civil Procedure dismissing the counterclaim asserted in the Objection by Trustee to Allowance of Claim and Counterclaim filed herein and for an order pursuant to Rule 12(f) of the Federal Rules of Civil Procedure striking the objection asserted therein, and argument being had thereon, and the Court having made its decision in writing and due deliberation having been had, it is, on motion of Sullivan & Cromwell, attorneys for Marine Midland Grace Trust Company of New York

Order of District Court Filed June 7, 1967 Granting Motion of Marine Midland Grace Trust Company of New York to Dismiss Counterclaim and Denying the Motion to Strike the Trustee's Objection to the Proof of Claim of Marine Midland Grace Trust Company of New York

ORDERED, that the motion to dismiss the counterclaim is granted, and the counterclaim is hereby dismissed, and it is further

ORDERED, that the motion to strike the objection is denied.

Dated: New York, New York
June 7, 1968

EDWARD C. McLEAN

U. S. D. J.

Notice of Appeal in 67 Civ. 1914, *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York*, from order of District Court, Filed May 20, 1968, Dismissing Complaint

Filed:
June 13, 1968

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

67 Civ. 1914

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant.

Sirs:

PLEASE TAKE NOTICE that Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., as Trustee, and on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954, hereby appeals to the United States Court of Appeals for the Second Circuit from the Order of Judge Edward C. Mc-

Notice of Appeal in 67 Civ. 1914, Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc. v. The Marine Midland Grace Trust Company of New York, from Order of District Court, Filed May 20, 1968, Dismissing Complaint

Lean, made and entered on the 20th day of May, 1968, in the United States District Court for the Southern District of New York, which dismisses his complaint.

Dated: New York, New York
June 12, 1968

MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER
Attorneys for Plaintiff
430 Park Avenue
New York, New York 10022

To:

SULLIVAN & CROMWELL, Esqs.
Attorneys for Defendant
48 Wall Street
New York, New York 10005

CLERK
United States District Court
Southern District of New York

Notice of Appeal in 65-B-365 from Order of District Court, Entered June 7, 1968, Denying Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

Filed:
June 13, 1968

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC. and Subsidiaries,

Debtors.

Sirs:

PLEASE TAKE NOTICE that Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., hereby appeals to the United States Court of Appeals for the Second Circuit from so much of the Order of Judge Edward C. McLean, made and entered on the 7th day of June, 1968, in the United States District Court for the Southern District of New York, which denies the motion of Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., to compel The Marine Midland Trust Company of

Notice of Appeal in 65-B-365 from Order of District Court, Entered June 7, 1968, Denying Trustee's Motion to Compel Marine Midland Grace Trust Company of New York to Account

New York to account as indenture trustee under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York dated as of June 1, 1954.

Dated: New York, New York
June 12, 1968

MARSHALL, BRATTER, GREENE,
ALLISON & TUCKER.
Attorneys for Trustee
430 Park Avenue
New York, New York 10022

To:

SULLIVAN & CROMWELL, Esqs.
Attorneys for The Marine Midland Grace
Trust Company of New York
48 Wall Street
New York, New York 10005

CLERK
United States District Court
Southern District of New York

Notice of Appeal in 65-B-365 from Order of District Court, Entered June 7, 1968, Granting Motion of Marine Midland Grace Trust Company of New York to Dismiss the Counterclaim of Trustee

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC. and Subsidiaries,

Debtors.

Sirs:

PLEASE TAKE NOTICE that Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., as Trustee, and on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954, hereby appeals to the United States Court of Appeals for the Second Circuit from the Order of Judge Edward C. McLean, made and entered on the 7th day of June, 1968, in the United States District Court for the Southern District of New York, granting the motion of The Marine Midland Grace Trust Company of New York and dismissing the

Notice of Appeal in 65-B-365 from Order of District Court, entered June 7, 1968, Granting Motion of Marine Midland Grace Trust Company of New York to Dismiss the Counterclaim of Trustee

counterclaim of Mortimer M. Caplin as Trustee in the Reorganization of Webb & Knapp, Inc.

Dated: New York, New York
June 12, 1968

MARSHALL, BRATTER, GREENE, ALLISON & TUCKER
Attorneys for Trustee
430 Park Avenue
New York, New York 10022

To:

SULLIVAN & CROMWELL, Esqs.
Attorneys for The Marine Midland Grace Trust Company of New York
48 Wall Street
New York, New York 10005

CLERK
United States District Court
Southern District of New York

Notice of Cross-Appeal by Marine Midland Grace Trust Company of New York in 65-B-365 from the Order of District Court, Entered June 7, 1968 Denying Motion to Strike the Trustee's Objection to the Proof of Claim of Marine Midland Grace Trust Company of New York

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 65-B-365

In Proceedings for the Reorganization of Corporations

In the Matter

of

WEBB & KNAPP, INC. and Subsidiaries,

Debtors.

Sirs:

PLEASE TAKE NOTICE that Marine Midland Grace Trust Company of New York hereby cross-appeals to the United States Court of Appeals for the Second Circuit from that part of the Order of Judge Edward C. McLean, made and entered on the 7th day of June, 1968, in the United States District Court for the Southern District of New York which denied the motion of Marine Midland Grace Trust Company of New York to strike the objection by Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., to the

Notice of Cross-Appeal by Marine Midland Grace Trust Company of New York in 65-B-365 from the Order of District Court, Entered June 7, 1968 Denying Motion to Strike the Trustee's Objection to the Proof of Claim of Marine Midland Grace Trust Company of New York

proof of claim of Marine Midland Grace Trust Company of New York.

Dated: New York, New York
July 2, 1968

SULLIVAN & CROMWELL
Attorneys for Marine Midland
Grace Trust Company of New
York
48 Wall Street
New York, New York 10005

To:

MARSHALL, BRATTER, GREENE, ALLISON
& TUCKER
Attorneys for the Trustee
430 Park Avenue
New York, New York 10022

Judgment of the Court of Appeals, March 3, 1971, Affirming Orders of the District Court on Consolidated Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of March one thousand nine hundred and seventy-one.

Present:

HON. J. EDWARD LUMBARD,
Chief Judge,

HON. LEONARD P. MOORE,
HON. HENRY J. FRIENDLY,
HON. J. JOSEPH SMITH,
HON. IRVING R. KAUFMAN,
HON. PAUL R. HAYS,
HON. ROBERT P. ANDERSON,
Circuit Judges.

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc. on behalf of Debentureholders under a Trust Indenture of Webb & Knapp, Inc., to the Marine Midland Trust Company of New York,

Plaintiff-Appellant,

SECURITIES & EXCHANGE COMMISSION,

Intervenor,

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant-Appellee.

(AND THREE OTHER CASES)

Judgment of the Court of Appeals, March 3, 1971, Affirming Orders of the District Court on Consolidated Appeals

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the orders of said District Court be and they hereby are affirmed without costs in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk

Opinion of the Court of Appeals, March 3, 1971, on Consolidated Appeals

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 327—September Term, 1970.

(Argued December 16, 1970 Decided March 3, 1971.)

En Banc ordered January 13, 1971

Docket No. 32586

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debenture-holders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Plaintiff-Appellant,

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Defendant-Appellee.

In the Matter of

WEBB & KNAPP, INC. and Subsidiaries, Debtors, MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC. and Subsidiaries,

Trustee-Appellant.

In the Matter of

WEBB & KNAPP, INC. and Subsidiaries, Debtors, MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC. and Subsidiaries,

Trustee-Appellant.

In the Matter of

WEBB & KNAPP, INC. and Subsidiaries, Debtors, THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Claimant-Appellant.

Opinion of the Court of Appeals, March 3, 1971, on Consolidated Appeals

Before:

LUMBARD, *Chief Judge*,
MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS
and ANDERSON, *Circuit Judges*.*

FRIENDLY, *Circuit Judge*:

We have three appeals and a cross-appeal from orders of Judge McLean concerning the reorganization of Webb & Knapp, Inc. under Chapter X of the Bankruptcy Act which is now pending in the District Court for the Southern District of New York. All relate to complaints by the Chapter X Trustee, Mortimer M. Caplin, concerning alleged failure on the part of The Marine Midland Grace Trust Company of New York ("Marine"), trustee under an Indenture whereunder Webb & Knapp issued unsecured debentures now outstanding in the amount of $4,398,200, to enforce certain covenants made by the debtor.[1]

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* Judge Feinberg took no part in the consideration or decision of this case.

[1] The breach concerns mainly, if not indeed solely, Section 3.6 of the Indenture. Webb & Knapp there covenanted that so long as any of the debentures remained outstanding, it would not incur or assume indebtedness resulting from borrowings or from the purchase of real property or interests in real property on which it would be personally liable, or to purchase any real property, or interests in real property, unless on the basis of computations (made as of the last day of the fourth month prior to such transaction) its "consolidated tangible assets" would equal 200% of certain liabilities. In determining "consolidated tangible assets" the Company was authorized, *inter alia*, to rely on and use appraisals made by its officers and approved by the Board of Directors "of real property, of interests in real property . . . or of the controlling stock interest in any corporation the principal assets of which consist of real property or interests in real property." The Company was required to file a certificate of compliance annually with Marine. In addition to such certificates Marine requested, as permitted by the

Marine had filed a proof of claim in the sum of $51,447.55 for services rendered and expenses incurred by it as indenture trustee. The Chapter X Trustee objected to this on the ground of Marine's alleged breach of duty and counterclaimed for damages in the amount of the debentures that remained outstanding. With the authorization of the district court, he also filed a plenary suit seeking the same relief. In addition he moved that Marine be required to file an accounting. Marine moved to dismiss the objections to its proof of claim, the counterclaim and the plenary suit. The judge held that grant of Marine's motions to dismiss the counterclaim and the complaint was required by *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943), but denied its motion to dismiss the objections. He also denied the Trustee's motion to compel Marine to account since there was no allegation that Marine had mishandled any funds which came into its hands as indenture trustee, and the only claim asserted by the Chapter X Trustee was the indenture trustee's alleged failure to enforce the negative covenant, a claim that would stand no better as a counterclaim to an accounting than as a plenary action or as a counterclaim to a proof of claim. Each party appealed from the decisions adverse to it.

After a panel consisting of Judges Moore, Kaufman and Hays had come to the conclusion that *Clarke* should be overruled, the court voted, in accordance with its usual practice in such cases, see *e.g. Indussa Corp.* v. *S.S. Ran-*

Indenture, and received separate officers' certificates stating specifically that Webb & Knapp was not in violation of § 23.6. In accordance with § 315 of the Trust Indenture Act of 1939, 15 U.S.C. § 77000 § 10.1 of the Indenture required Marine to examine all reports furnished to it but authorized it, in the absence of bad faith, to rely upon certificates or opinions conforming to the requirements of the Indenture. The Chapter X Trustee claims that although the reports for 1959-63 showed asset-liability ratios ranging from a high of 258.30 in 1961 to a low of 200.56 in 1963, Marine should have known that the appraised values were inflated.

borg, 377 F.2d 200 (2 Cir. 1967), to consider the appeals *in banc* upon the briefs already filed. A majority of the full court have concluded that *Clarke* was correctly decided and, since this case is admittedly not distinguishable, that the dismissal of the counterclaim and the plenary suit should be affirmed. We are all of the view that the orders denying the Trustee's motion to require Marine to account and refusing to strike his objections to Marine's claim should be affirmed.

Clarke was an action by the Chapter X Trustee of Associated Gas and Electric Company (Ageco) against the Chase National Bank, trustee under an indenture for debenture holders. Broadly speaking the complaint contained two differing sets of counts. The first and third alleged that Chase, in breach of its duties as indenture trustee, had failed to enforce certain covenants against the mortgage or pledge of Ageco's property or its merger into another corporation and sought to recover losses suffered by the debenture holders in consequence. The second count sought recovery of $4,000,000 allegedly received by Chase from Ageco in payment of an indebtedness, though Chase knew the latter was insolvent or in imminent danger of insolvency; the fourth count alleged that Chase had received a preference in respect of $4,249,000 of Ageco debentures owned by Chase, through an unfair exchange with Ageco's subsidiaries of these debentures for securities of greater value, at a time when Chase knew Ageco was insolvent.[2] The court unanimously reversed an order dismissing the second and fourth counts. A majority, with Judge Augustus N. Hand writing for himself and Judge Chase, upheld an order of a different judge dismissing the first and third counts; as to this Judge Learned Hand dissented.

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[2] A fifth count sought to recover $40,000 that had been paid Chase as trustee's fees, which the district court had dismissed with leave to amend; the court dismissed the appeal from this order for lack of appellate jurisdiction, 137 F.2d at 801.

Opinion of the Court of Appeals, March 3, 1971, on Consolidated Appeals

The majority in *Clarke* reasoned that, assuming liability, "we cannot see that the claims for breach of the covenants are any part of the property of the bankrupt or would affect the plan of reorganization"; they were rather claims "of the debenture-holders not derived from the bankrupt's estate but arising through the alleged tortious action of the indenture trustee." 137 F.2d at 800. They cited the earlier decisions in *In re 1775 Broadway Corp.*, 79 F.2d 108 (2 Cir. 1935), that the reorganization court has no jurisdiction to force nonassenting noteholders to release claims against an indenture trustee for misrepresentation in the sale of the notes, since these were not claims against the debtor or its assets or claims that must be settled to bring property into the reorganized company, and in *In re Nine North Church Street, Inc.*, 82 F.2d 186 (2 Cir. 1936), that the reorganization court has no jurisdiction to enjoin nonassenting certificate holders from suing the guarantor of a mortgage on the debtor's property since the suit was to enforce a personal right against the guarantor and did not concern property subject to reorganization. Judge Learned Hand argued that the indenture trustee had a duty to prevent the violation of the covenants in the indenture, 137 F.2d at 802, which was true enough, and then asked "In what way does that [breach of duty] differ from allowing a debtor, in violation of the mortgage, to substitute improper collateral?" The answer was that in the latter case the mortgage trustee would have dealt improperly with property of the bankrupt. Judge L. Hand himself had based his opinion in *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2 Cir. 1939), on the ground that there the accounting dealt with property of the debtor which trustees for secured creditors had allegedly surrendered in breach of the trust, and that the rights of the creditors to compel them to restore the *res* was within the "extended"

concept of the debtor's property in a reorganization.[3] He was there careful, however, to distinguish the case in which the creditors asserted rights having "nothing to do with the *res* and [which] would not restore it" and "had nothing to do with anything that had ever been the debtor's property, or with the distribution of any part of it." *Id.* at 132. This distinction, apparently lost sight of in his dissent in *Clarke,* had been further developed by Judge Frank in *Brooklyn Trust Co.* v. *Kelby,* 134 F.2d 105, 110-12, 116 (2 Cir.), *cert. denied,* 319 U.S. 767 (1943).

A year and a half after *Clarke,* a panel consisting of the three other judges of the court as it then stood, Swan, Clark and Frank, decided the complicated case of *President and Directors of Manhattan Co.* v. *Kelby,* 147 F.2d 465 (2 Cir. 1944), *cert. denied,* 324 U.S. 866 (1945). The unanimous opinion was written by Judge Frank, who had long been expert in reorganization matters and was a member of the SEC when Chapter X was adopted, in no small measure at its instance. The court took a broad view of the rights of reorganization trustees against a trustee under an indenture but stopped when it came to an issue similar to that here presented. One of the claims of the Chapter X Trustees was that the indenture trustee was liable in damages for failing to enforce a covenant of Prudence-Bonds Corporation to deposit a guarantee by the Prudence Company. Although recognizing that such damages might be considerable, the court held that "an action for those damages is not one for restoration of the [trust] fund" and "cannot be maintained in connection with the bankruptcy proceedings," 147 F.2d at 478, citing *Brooklyn Trust Co.* v. *Kelby, supra,* 134 F.2d at 111.

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[3] The "extension" was that in some instances the Chapter X trustee may be able to recover property of the company which the debtor, because it might be barred by a defense of consent or estoppel, could not. See *McCandless* v. *Furlaud,* 296 U.S. 140, 159-61 (1935).

It is with this background that we come to *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555, 558 (2 Cir.) *cert. denied*, 346 U.S. 835 (1953), more particularly to Judge Learned Hand's opinion on rehearing. The Chapter X Trustee regards this as fundamentally inconsistent with *Clarke*, which the opinion did not mention. In our view the reason for failing to mention *Clarke* was that for grounds clearly stated by Judge Hand, there was no inconsistency.

The holdings in *Prudence-Bonds* with which we are concerned were (1) that the Chapter X Trustees could have maintained an action against an indenture trustee for failure to enforce a "Secondary Guaranty" by the Prudence Company of mortgages held by the indenture trustee as security for the bondholders, and (2) that this right had been conveyed to the reorganized company. Indeed it is only the first holding that is of real interest here. Its justification was thus stated, 202 F.2d at 561:

> But by the Secondary Guaranty the Guarantor became a surety for the performance of the mortgagors, just as the mortgages were a surety for the same performance. The only difference between them was that in one case the security was the promise of a third person and in the other it was a lien upon property. The promise was a part of the *res* in precisely the same sense that the promises were in the policies of fire and title insurance, mentioned in Article 1, § 2. As we have said, it was in effect the equivalent of a policy of credit insurance of the mortgagors.

The significance of this was heightened by the distinction drawn between the indenture trustee's failure to enforce the "Secondary Guaranty" and the "Primary Guaranty," i.e., a guarantee by the Prudence Company of the bonds of Prudence-Bonds themselves. While the court said it

"need not answer" the question whether this "was also a part of the *res*," the opinion in effect did so when it said that this "was a promise to pay the Debtor's obligations, and had nothing to do with the *res*." *Id.* It was the Primary Guaranty which was like the claim sought to be pressed in *Clarke*, and here.[4] Far from being indistinguishable, as the dissent claims, *Prudence-Bonds* differs from this case and from *Clarke* on the very ground Judge Hand was at such pains to clarify. If Marine had held property of Webb & Knapp through pledge or, for example, as a result of payments into a sinking fund, the Chapter X Trustee could sue under *Prudence-Bonds* for mismanagement of such assets, since he would be asserting a claim to property of the debtor which the indenture trustee had held. Here, as in *Clarke*, he is not. The difference between failure to enforce a third party's guaranty of a mortgage assigned to an indenture trustee or other property held by it as security and failure to enforce a promise by the debtor is the highly significant one that the former has diminished the debtor's estate and the latter has not.

The collapse of the argument of the Chapter X Trustee based on *Prudence-Bonds* does not, of course, mean that we could not overrule *Clarke* if we were convinced that Judges Augustus Hand and Chase had been in error. But we are not.

It is necessary in the first instance to consider what effect a recovery by the Chapter X Trustee would have

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[4] We do not regard *In re Solar Mfg. Corp.*, 200 F.2d 327 (3 Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953), as in conflict with *Clarke*. Although we would not be persuaded by the procedural distinction made at p. 332 n. 6, the counterclaim against the Indenture trustee there sustained was for failure to earmark $450,000 it had received upon the sale of certain of the debtor's property. Since the claim was for failure to keep funds of the debtor which the indenture trustee was bound to hold in trust, the court concluded that the cause of action was "quasi in rem for the benefit of the trust" and "for the restoration of trust funds." *Id.* at 332.

on the reorganization. On a superficial view this might seem substantial—if, for example, the Chapter X Trustee were to achieve a complete recovery, the debenture holders would be paid off and it might seem there would be that much more for the other creditors and the stockholders. But this pleasant prospect speedily evaporates when the law of subrogation is brought into play. As a result of subrogation, Marine would simply be substituted for the debenture holders as the claimant. Cf. ALI, Restatement of Security § 141 (1941). If the Chapter X Trustee recovered judgment in a lesser amount, the claim of the debenture holders would still be provable in full, with the division of the proceeds between them and Marine dependent upon the results of the reorganization, and other creditors or stockholders would not be affected. Indeed, even these hypotheticals put the case too favorably for the Chapter X Trustee, since we do not see the answer to Judge A. N. Hand's observation in *Clarke, supra*, 137 F.2d at 800.

> Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants.

The claim against Marine thus could not be prosecuted to judgment until the results of the reorganization become known.[5]

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[5] Caplin argues that failure to allow suit by him would leave the debenture holders without remedy against Marine as a practical matter, since under *Elkind* v. *Chase Nat'l Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept.), *aff'd* 284 N.Y. 726 (1940), each would have to sue individually. Apart from other possibilities under F.R. Civ. P. 23, we would not regard it as unlikely that a class action could be maintained in federal court for violation of § 315 of the Trust Indenture Act of 1939, although, of course, we are not to be understood as so deciding.

Equally important to the *Clarke* decision was the necessity, 137 F.2d at 801, under F. R. Civ. P. 17(a), here applicable by virtue of General Order in Bankruptcy 37, that "Every action shall be prosecuted in the name of the real party in interest." To determine whether Caplin has that status, we look to the Bankruptcy Act.

Sections 186 and 187 provide that a Chapter X trustee "shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor." Section 70a vests a trustee appointed under § 44 "with the title of the bankrupt" to eight types of property therein described. None of these, by the remotest stretch of language or even of imagination, could include the claims of debenture holders against an indenture trustee for permitting the debtor to violate covenants made by the debtor to the indenture trustee for the bondholders' protection. The bankruptcy trustee's task is to "collect and reduce to money the property of the estates for which they are trustees," § 47. While the reorganization trustee's added duty, § 167(3), to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate," may be broad enough to authorize him to report whether in his opinion an indenture trustee has failed in its duties to debenture holders and this may assist the latter in asserting their rights, nothing in the statute allows him to collect any moneys or other property not owed to or owned by the estate although, as indicated see fn. 3, he may sometimes be able to recover an insolvent corporation's property when the corporation itself might be subject to a defense of consent or estopped.

Any other view would, for example, allow a Chapter X Trustee to settle claims of debenture holders against third parties with the approval of the reorganization court, and would, in principle, sanction a plan of reorganization providing for a partial or even total release of such claims. Yet § 216(2) says that the plan "may deal with all or any part *of the property of the debtor*" (emphasis supplied) and § 216(13) directs that it "may include provisions for settlement or adjustment of *claims belonging to the debtor or to the estate*" (emphasis supplied). The debenture holders' claims against Marine simply do not fit under those rubrics.

The Reorganization Trustee relies heavily on statements from the legislative history of Chapter X, such as that in the House Report, H.R. Rep. 1409, 75th Cong., 1st Sess., pp. 43-44 (1937), that "There must be power and responsibility in the hands of a qualified representative of investors." It was exactly in this spirit that Chapter X was read in its early years by the judges who sat on this court in the 1940's, one of whom, as noted, had played no small role in its enactment. These were not judges who read statutes in the niggling way condemned by Mr. Justice Holmes, "We see what you are driving at, but you have not said it, and therefore we shall go on as before." *Johnson* v. *United States*, 163 F. 30, 32 (1 Cir. 1908). But they could find nothing in Chapter X, as we cannot, to indicate that Congress was "driving at" allowing a trustee to enforce claims not belonging to the estate. Now that the issue has again been raised after so many years, Congress may wish to consider whether it is possible and, if so, desirable to go further and permit the trustee to enforce individual claims of security holders against third parties.[6]

[6] An affirmative answer should not simply be assumed. Apart from possible question whether the bankruptcy power extends to claims of creditors against solvent third parties, which Congress might not think it worthwhile to raise, there would be serious prob-

That is a policy decision to be made by the legislature, not by our overruling soundly reasoned decisions of our distinguished predecessors, who knew the statute every bit as well as we do and construed it to mean what it rather clearly says. We therefore affirm Judge McLean's dismissal of the Chapter X Trustee's counterclaim and plenary suit.

We are all in accord with the decision of the panel to affirm the district court's denial of the Trustee's motion for an accounting. Although § 212 gives the reorganization court power to enforce an accounting under instruments whereby any one of a number of persons, including an indenture trustee "purports to represent any creditor or stockholder," this does not authorize the court to require an "accounting" by an indenture trustee when there is no claim that he holds property belonging to the debtor or any security holder, or has mishandled any such property in the past.

We likewise are in accord with the panel's decision affirming the denial of Marine's motion to strike the Chapter X Trustee's objections to its proof of claim. Marine claims it is entitled to be paid its pro-rata share out of the debtor's property for services it rendered as the indenture trustee, whereas Caplin contends it did not perform the services

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lems if other states have rules like that prevailing in New York before 1950 that transfer of a bond does not carry accrued claims against trustees or guarantors. See *Elkind* v. *Chase Nat'l Bank, supra*, 259 App. Div. 661, 20 N.Y.S.2d 213, *overruled in part by statute*, L. 1950 c. 812 N.Y. Personal Property Law § 41, 4, contracts. *Welch* v. *Northern Bank & Trust Co.*, 100 Wash. 349, 170 P. 1029 (1918), or when such claims had been reserved by agreement. With no showing that the *Clarke* decision had caused any real difficulty over the past twenty-seven years, Congress might well decide that it was best to adhere in the policy of allowing holders of the bonds of debtors in reorganization to pursue their own remedies against third parties.

it should have performed. We cannot say that the objection, if well founded in fact, would not be valid in law. As already indicated, even though the debtor corporation here might have been estopped to assert failure of consideration as a defense to the trustee's claim, as Marine argues, it does not follow that the reorganization trustee may not do so.[7]

The orders of the district court are affirmed. No costs.

KAUFMAN, *Circuit Judge* (with whom Judge Hays concurs), dissenting in part:

I see no justification for continued adherence to the long since eroded rule announced over Judge Learned Hand's vigorous dissent in *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943). I would permit Caplin to assert his counter-claim and maintain the plenary action.

Indeed, Judge Hand himself in effect announced the demise of the *Clarke* rule in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), without saying so expressly. The plaintiff in *Prudence-Bonds*, like Caplin, sought redress on behalf of bondholders for the alleged default by the trustee of a bond indenture. The reorgazined corporation, successor to the reorganization trustee and proceeding pursuant to an order of the bankruptcy court, alleged that the indenture trustee had negligently failed to demand payment by a guarantor of a mortgage pledged to the indenture trustee as security for the bonds, following the mortgagee's default. Although at the time of the default and for a period thereafter the guarantor was solvent and presumably could have made good on its guarantee, the guarantor's insolvency followed close upon that of the debtor. Learned Hand, joined by

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[7] We need not consider whether a determination of the objection in favor of the Chapter X Trustee might enure to the benefit of the debenture holders in an action by them under the principle of *Zdanok* v. *Glidden Co.*, 327 F.2d 944 (2 Cir.), *cert. denied*, 377 U.S. 934 (1964).

Chief Judge Swan and Judge Frank, found that the broad authority of the reorganization court to implement a reorganization plan furnished ample authority for the newly reorganized corporation to assert before the bankruptcy court the liability of the indenture trustee "to the bondholders for any loss that resulted" from that trustee's alleged breach. *See* 11 U.S.C. §§ 621-29.

In its brief on appeal, Marine attempted to distinguish *Prudence-Bonds* in several respects, but each is inconsequential. The relevance of the assertion that Marine successfully opposed Caplin's application for an accounting by Marine or that Marine is not now seeking a release as trustee, escapes me altogether. Such considerations would seem to bear more on jurisdiction than standing. And the claim that the bondholders' interests here are unsecured, unlike those in *Prudence-Bonds,* is also of no moment. Moreover, I would not attribute to Congress the perverse purpose of permitting a bankruptcy court to authorize a corporation already reorganized to assert bondholders' claims against the indenture trustee, as in *Prudence-Bonds,* while denying it the power to dispose of those claims in more orderly fashion by permitting the trustee to raise them *before* the reorganization plan has jelled.

The majority concedes that *Prudence-Bonds* is indistinguishable in any of these respects, but suggests that it may be explained away on yet another ground. The opinion tells us that a Chapter X trustee may proceed against an indenture trustee for failure to enforce a guaranty *by a third party* that secures the trust, res, as in *Prudence-Bonds,* but not for failure to enforce a promise *by the debtor himself* contained in the trust indenture, as here, which also protects and secures the trust res. This anomalous result is said to be forced upon us because of language in Learned Hand's *Prudence-Bonds* opinion having nothing to do with that court's discussion of the standing problem.

But when a hypothesis as to a law's meaning is seen to yield such awkward conclusions, it is perhaps better to re-examine the hypothesis than to ascribe to Congress an intent to fashion so irrational a design. In this instance, the pressure to ascribe such an intent is very slight indeed. For in purporting to set forth the reasoning of the *Prudence-Bonds* court with respect to the standing problem, 202 F.2d 555 at 560, the majority relies entirely on dictum which occurs in the court's later analysis of the merits of the successor corporation's action against the trustee. 202 F.2d at 561. The finding of standing in *Prudence-Bonds* is not premised at all on this dictum, but rather "on the broad implementary powers of a judge when a plan is confirmed" and specifically on an order of the reorganization court permitting the new corporation to pursue "*any* objections" (emphasis added) to the indenture trustee's accounts "on its own behalf and on behalf of" the bondholders. There is no basis in the *Prudence-Bonds* opinion for limiting this langauge, which clearly would comprehend such an action as Caplin's, by transposing into the court's discussion of standing later dictum intended to bear—and even then incidentally and by way of speculation and musing—only on the merits of the new corporation's action, and not on its right to bring it.

In distinguishing *Prudence-Bonds* the majority is compelled to rely on dictum in the opinion irrelevant to the question presently before this court. But, we can understand this, for otherwise the majority would be required to show in detail why there should have been standing in *Prudence-Bonds* under the rationales that it advances to support its decision today. My brothers rightly conclude, and no one has asserted otherwise, that Caplin's claim against Marine could not "by the remotest stretch of language or even of imagination" be considered an action to "collect and reduce to money the property of the [estate] for which" Caplin is trustee, citing Section 47 of the

Bankruptcy Act. But it requires no lesser feat of linguistic gyration to conclude that the action in Prudence-Bonds was such an action. The action in *Prudence-Bonds* was one for an accounting for the loss to the bondholders, on behalf of the bondholders alone, that resulted from the indenture trustee's breach of a negative covenant, as here. It was not in any sense an action for restoration of the trust fund or the debtor's property (unless Caplin's action may also be so described). Indeed L. Hand specifically observed that "the breach was at most a failure properly to protect a part of the *res*"—which is precisely the situation here—"and not a 'surrender or release' " of the res. 202 F.2d at 559.

This is not the end of the majority's difficulties with *Prudence-Bonds*. My brothers go to great lengths to show —wrongly, I believe—that "other creditors or stockholders would not be affected" by Caplin's action in this case. But the reorganization in *Prudence-Bonds* had already been effected and would not likely to be altered retrospectively. Even had the suit been brought before a plan had been approved, the recovery would have inured to the benefit of no one but the bondholders, as is the case here.

There is a more fundamental answer, however, to the argument that only one class of creditors will be affected if Caplin recovers. Although the bondholders' recovery will swell directly only the purses of the bondholders, the majority ignores the central consideration that certainty as to the bondholders' rights against the indenture trustee cannot fail to affect the views of the interested parties and the court in passing on the fairness of the reorganization plan. 11 U.S.C. § 621(2). The majority thus seems to misconstrue the true scope and nature of a reorganization proceeding. The process of reorganizing is not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed for-

mulas. Rather, the objective is carried out through a process of negotiation, and some give-and-take, in an attempt to adjust equitably and with sensitivity to the nuances of the individual case the rights of competing interested parties. As Judge L. Hand argued persuasively in dissenting from the decision in Clarke, the reorganization court has jurisdiction over a case such as this as part of its obligation to "adjust the mutual rights of the debtor's creditors as between themselves." 137 F.2d at 802. I see no reason for denying to the reorganization court, as the majority does, the power to discharge this obligation here or properly to perform its duty to adjudge the equitableness of a proposed reorganization plan.

This latter consideration is particularly relevant to this case, where it appears that the indenture trustee may be implicated in the causes for Webb & Knapp's bankruptcy. As Judge Hand put it, "the trustee should have prevented the debtor from siphoning its assets away from its creditors—the bondholders along with the other general creditors. . . . The loss was . . . of the debtor's assets; the remedy will be in their restoration; I do not understand how that can be alien to a reorganization." 137 F.2d at 802.

Thus, the parade of horribles which my brothers assert would follow if Caplin were allowed to bring this claim —including virtually the confiscation of property of parties with no semblance of due process—is a phantasm. We are concerned here only with the standing of a trustee in reorganization to *assert* the claims of creditors, not to *cancel* them, where the reorganization trustee asserts that creditors have been damaged along with all other parties to the reorganization by the indenture trustee's negligent failure to protect the debtor's assets. It is a very narrow proposition that the majority rejects, not an infinitely expandable one. By rejecting it, the majority retreats from this court's previously declared commitment to the flexible approach announced in *Prudence-Bonds.*

Moreover, the view of the majority appears significantly narrower than that of the *Clarke* majority. That court was unwilling to constrict itself to the narrow "property" analysis advanced by the majority, but suggested instead that the indenture trustee might have standing if "the claims for breach of the covenants [were] any part of the property of the bankrupt *or* would affect the plan of reorganization." (Emphasis added.) 137 F.2d at 800. Immediately following this sentence, the *Clarke* court launched upon an extended discussion of the question whether the claim would affect the plan after which it appended, almost as an afterthought, the observation that "Moreover the trustee . . . has no title to the claims embraced in the first and third counts. . . ." Although I believe that the *Clarke* majority was in error to hold that the claim would not affect the plan, its analysis was considerably broader than that adopted by my brothers.

Finally, the result today ill serves two reforms central to the scheme of the Chandler Act: to promote the collection and dissemination of all information relevant to the debtor and its affairs and to involve the Securities and Exchange Commission in complex reorganization proceedings as an advisor or friend of the court, a role it has assumed as a party to this appeal, in urging us to permit Caplin to pursue his claims. See H. Report No. 1409 on H.R. 8046, 75th Cong., 1st Sess., 47-48 (1937).

The reorganization trustee is empowered to undertake a comprehensive investigation into the history and financial condition of the debtor by 11 U.S.C. § 567. To compel the bondholders in these circumstances to proceed individually or in a separate class action, would only give rise to a massive redundancy of fact-finding. To restate the point somewhat more positively, a fair adjudication of the issue between the bandholders and Marine will be promoted if

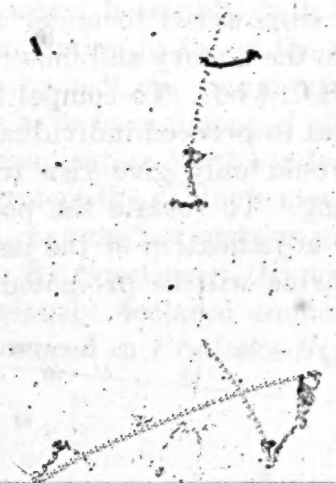
the information available to the trustee is efficiently brought to bear in that dispute and revealed to the court.[1]

Scrutiny or active participation by the SEC is provided for by numerous provisions of Chapter X (11 U.S.C. §§ 561, 567(5), 571-74, 590, 608, 622). On few issues is that agency's expertise more relevant than in a case such as this, involving the adjudication of rights and duties of a trustee functioning under the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.* This expertise will be available in a reorganization proceeding but ordinarily not in individual or class action bondholders' suits.

In short, today's decision not only retreats from past precedent but is contrary to the purposes which motivated Congress to enact the Chandler Act.

---

[1] The manifest inconvenience of the *Clarke* rule is magnified in a case where, as here, the indenture trustee filed a claim against the estate of the debtor for his services as trustee. A determination of the merits of Caplin's plenary action and counter-claim will not require the bankruptcy court to investigate any matters that it would not have to pass upon in adjudicating Caplin's objection to Marine's claim.



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IN THE

Supreme Court of the United States

October Term, 1971

No. 1763 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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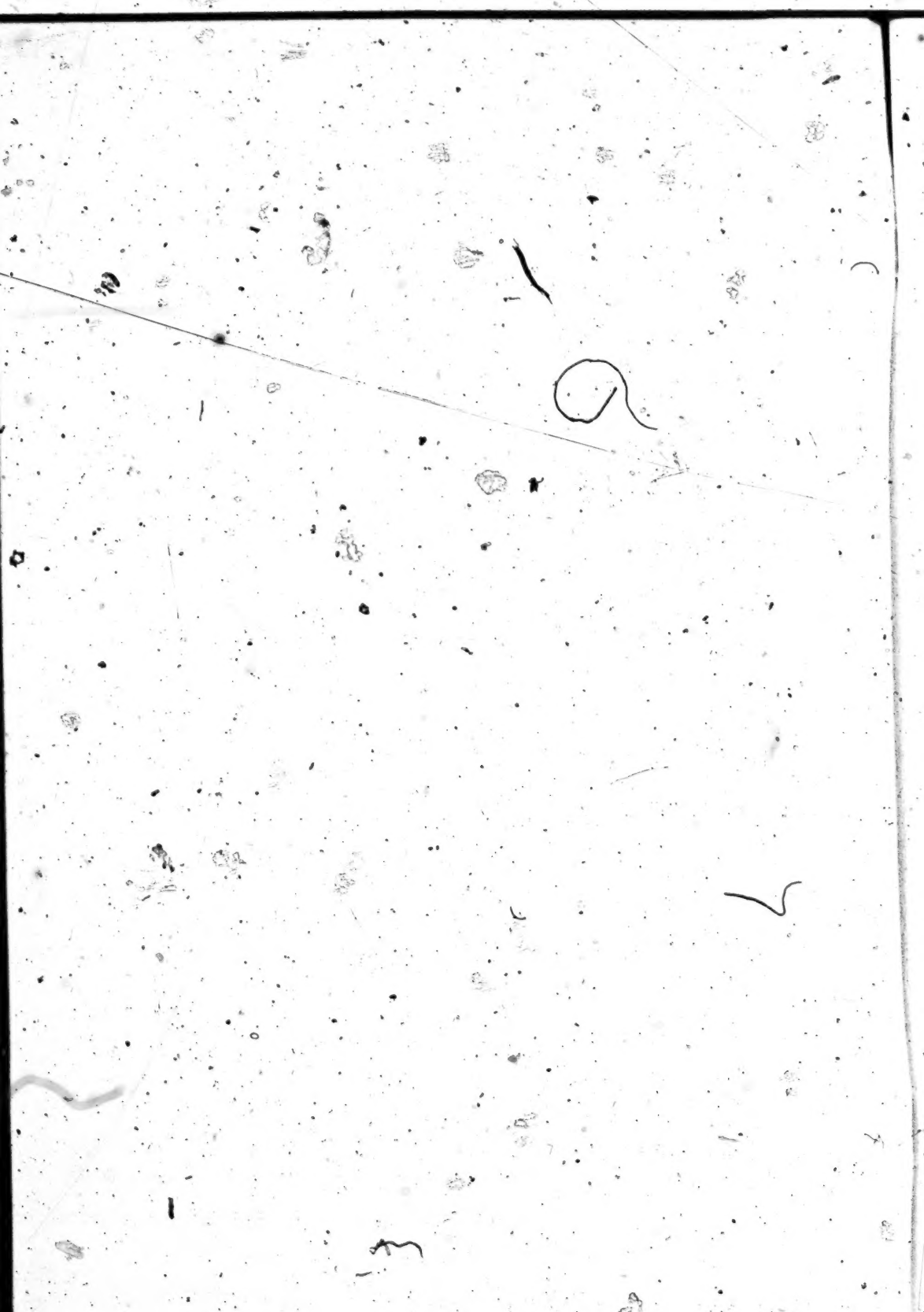

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IN THE

Supreme Court of the United States

October Term, 1971

No. .....

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered March 3, 1971.

Opinions Below

The opinion of the Court of Appeals is reported at 439 F.2d 118 (2d Cir. 1971). The opinions of the District Court have not been reported.

Jurisdiction

The judgment of the Court of Appeals was dated and was entered March 3, 1971. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Question Presented

Is the trustee in reorganization of a debtor pursuant to Chapter X of the Bankruptcy Act barred, as lacking standing or not being the real party in interest, from prosecuting a claim on behalf of the debtor's debenture-

holders against the indenture trustee for willful misconduct or gross negligence in failing to enforce covenants of the debtor contained in the trust indenture?

Statutes Involved

Pertinent portions of section 212 of the Bankruptcy Act and the Trust Indenture Act of 1939 are set forth in the appendix, *infra* at 29a.

Statement of the Case

Petitioner, the Chapter X Trustee of Webb & Knapp, Inc., seeks review of a judgment of the Court of Appeals holding that petitioner lacked standing to prosecute claims, on behalf of the holders of the debtor's debentures, against the respondent, which was the trustee of the debentures under a trust indenture dated June 1, 1954.

The claims sought to be asserted are grounded on respondent's failure to enforce a covenant in the indenture which prohibited the debtor from purchasing real property or incurring new indebtedness unless it maintained a defined asset-to-liability ratio of at least 200%. Each year the debtor submitted a certificate of its officers stating that no default had occurred, together with a statement purporting to show the asset-to-liability ratio as of the preceding December 31. Those statements, as permitted by the trust indenture, were based upon the value of the debtor's interest in real property as appraised by officers of the debtor, and the appraisals were submitted with the certificates.

Petitioner claims that the appraisals were false and fraudulent in that they were grossly inflated. Petitioner contends that at no time during the years 1958 to 1964 did the debtor maintain the required asset-to-liability ratio, but that the debtor, in violation of the trust indenture, purchased real property and incurred indebtedness throughout the period. Petitioner further claims that the inflated nature of the appraisals of the debtor's real prop-

erty was apparent on their face and that the increments in value of individual properties from year to year, as shown in the appraisals, were so enormous as to make them inherently suspect.[1]

In addition, the debtor, commencing with the appraisal for the year 1958 affixed a note to the appraisals that they represented the officers' "view as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established". Petitioner contends that the note put respondent on notice that the appraisals did not comply with the indenture and were inflated. Respondent, however, took no action to compel the debtor to comply with the indenture.

Respondent, by failing to prevent the debtor from purchasing property and incurring indebtedness, was guilty of willful misconduct or gross negligence, by reason of which the debenture holders were damaged. Petitioner claims damages of $4,298,200, the principal amount of the outstanding debentures.

Petitioner obtained authorization of the reorganization court to prosecute the claims by commencing a plenary action against respondent and in addition by filing an objection and counterclaim to respondent's proof of claim filed in the reorganization proceeding. Petitioner also sought an order in the reorganization court to compel respondent to account, so that a counterclaim could be asserted in the accounting proceeding.

---

[1] Thus one major parcel of land of the debtor, designated as the Baychester property, was shown on the officers' appraisals as of December 31, 1957 as having a value of $15,000,000. The following year it was appraised at $27,000,000. The appraisal for 1959 was $64,000,000 and for 1963 it reached $91,000,000. There were no significant improvements to the land involved. During this period, the only changes which affected the Baychester property were the additions of land at a cost of $1,200,000 and the execution of a lease to Freedomland, Inc. of a large portion at an initial annual net rent of $600,000.

The District Court had jurisdiction of the action and the proceedings relating to respondent's proof of claim and to compel respondent to account under section 2 of the Bankruptcy Act, 11 U.S.C. § 11.

The District Court dismissed the complaint in the plenary action and the counterclaim to respondent's proof of claim. It also denied petitioner's petition to direct an accounting. It denied respondent's motion to strike the objection to its proof of claim, however.

Two of the three judges of the Court of Appeals before whom the consolidated appeals were heard would have reversed and overruled the earlier case of *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). The appeal was thereupon referred to the Court *in banc*, which, without hearing oral argument but relying solely on the briefs, affirmed the orders of the District Court, Judges Kaufman and Hays dissenting.

Reasons for Granting Writ

A. The legislative purpose of Chapter X and the Trust Indenture Act require that a reorganization trustee have standing to prosecute claims of debenture holders.

This case raises serious questions about the role of a Chapter X trustee in the prosecution of bondholder's claims against indenture trustees. The problem is a recurring one, and the cases are in conflict, as is more fully discussed below. At issue in this case are the rights of the holders of over $4,000,000 in face value of Webb & Knapp debentures. Moreover, the rights of the holders of billions of dollars worth of other bonds and debentures are directly affected.[2] A debtor which defaults in payment of publicly-

[2] During the ten-year period ending June 30, 1970, there were public offerings of debt securities in the United States which totaled $87 billion. The most recent four-year period showed a striking increase in the public issuance of such securities: $12 billion in fiscal 1967, $14 billion in 1968, $11 billion in 1969 and $18 billion in 1970. SEC, 36th Annual Report (1970) 215.

issued debt securities is more than likely to be placed in reorganization under Chapter X. The unsettled role of the reorganization trustee with respect to bondholder's claim can only be resolved by this Court.

The question is simply whether a claim for relief, on behalf of debenture holders, against an indenture trustee, may be prosecuted by the Chapter X trustee, or whether the debenture holders must be left to their own devices.

Actions by the individual debenture holders are difficult to prosecute because they, unlike the reorganization trustee, do not have ready access to the debtor's records and do not have the power to investigate given the Chapter X trustee by Section 167 of the Bankruptcy Act. The debenture holders, who may have unquestioned standing and be undoubted real parties in interest, are in fact unlikely even to know a claim for relief exists. This is particularly true where, as in this case, the indenture trustee represents the debenture holders in the reorganization proceeding.[3]

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[3] Debenture holders face a further problem in jurisdictions which follow the New York rule of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), *aff'd* 284 N.Y. 726. That case held that (1) a cause of action against an indenture trustee which does not involve a surrender or release of trust assets does not pass to the transferee upon assignment of the bond, and (2) a class action may not be prosecuted on such claims. Although the first aspect of the doctrine was changed by statute, now. New York General Obligations Law § 13-107, the prohibition against class actions remains uncertain. In *Lewis* v. *Marine Midland Grace Trust Co.*, New York Law Journal, June 28, 1968, page 12, col. 2, the *Elkind* Rule was followed in dismissing a class action brought by a Webb & Knapp debenture holder on the same claims as are in issue in this case. More recently *Elkind* was rejected in *Ray* v. *Marine Midland Grace Trust Co.*, New York Supreme Court, New York County, Index No. 2159-1967, January 8, 1971, appeal pending, an action by a different Webb & Knapp debenture holder.

The Chapter X trustee, on the other hand, is the logical person effectively to prosecute such an action. He possesses the records of the debtor, he has the knowledge gained from his examination, he possesses the facilities to conduct complex litigation, and he acts under the supervision of the reorganization court and the scrutiny of the Securities and Exchange Commission.

Whether a Chapter X trustee may prosecute such claims is a question which must be considered in the light of the function of a reorganization trustee and the purpose of the Chandler Act. As the leading commentator states:

> "Chapter X thus represents the present culmination of the long struggle to resolve the many legal, economic and social difficulties inherent in the search for a satisfactory procedure that achieves an equitable reorganization." 6 Collier on Bankruptcy ¶ 0.01.

One of the principal concerns of Chapter X is protecting the interests of the holders of the debtor's publicly held securities. The statute provides for active participation by the SEC. Bankruptcy Act, Sections 161, 167, 171-175, 179, 190, 208, 222 and 265, 11 U.S.C. §§ 561, 567, 571-574, 579, 590, 608, 622 and 665. The House Report on the Chandler Act stated:

> "It would be idle to provide that protective measures be adopted without likewise providing the means whereby such protection can be afforded. * * * There must be power and responsibility in the hands of a qualified representative of investors. * * * Investors must be afforded a 'focal point' for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest." H. Rep. 1409, 75th Cong., 1st Sess. (1937) 43-44.

Additional support for the petitioner's standing is found in the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.* That statute was enacted in response to

an SEC report which had shown that trust indentures typically were drafted to exculpate the indenture trustee from responsibility or liability, leaving bondholders without effective remedies. 2 Loss, Securities Regulation (2d Ed.) 719-725; and see, *e.g., Hazzard* v. *Chase National Bank,* 159 Misc. 57, 287 N.Y.S. 541, 569-570 (Sup. Ct. N.Y. Co. 1936), *aff'd* 257 App. Div. 950, 14 N.Y.S. 2d 147 (1st Dept. 1939), *aff'd* 282 N.Y. 652 (1940), *cert. denied* 311 U.S. 708. The statute itself expressly sets forth the reasons for the legislation, including the need to impose affirmative duties upon indenture trustees to protect investors, 15 U.S.C. § 77bbb(a)(2). It was declared to be the policy of the Act to eliminate the existing practices which were criticized, 15 U.S.C. § 77bbb(b). That policy is effected by, among other things, prohibiting exculpation of the indenture trustee "from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct" with exceptions for certain acts performed or omitted in good faith, 15 U.S.C. § 77ooo(d). Jurisdiction of actions to enforce liabilities created by the Act is given to district courts of the United States, 15 U.S.C. § 77vvv.

Just as private causes of action were created by Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), see e.g., *Fischman* v. *Raytheon Mfg. Co.,* 188 F.2d 783 (2d Cir. 1951); *Speed* v. *Transamerica Corp.,* 235 F.2d 639 (3d Cir. 1956), so the Trust Indenture Act has created causes of action. See *Kardon* v. *National Gypsum Co.,* 69 F. Supp. 512, 513 (E.D. Pa. 1946) ("The disregard of the command of a statute is a wrongful act and a tort.")

The claims which the Trustee seeks to enforce are thus created by an Act of Congress which, like Chapter X itself, is part of the overall legislative program to protect the investing public. It certainly was not the intent of Congress, after establishing new standards of conduct for indenture trustees, to leave no effective means for enforcing

them. The narrow construction of the Court below would frustrate legislation which was intended to have a broad remedial effect.

The question of standing of a reorganization trustee to sue on behalf of others has never been decided by this Court. The lower courts have considered the problem in a variety of contexts, but have not achieved consistent results, as is shown by the cases discussed at pages 12-16 *infra*. In one recent Chapter X proceeding, the reorganization trustee obtained a settlement on behalf of debenture holders against an indenture trustee which allegedly failed to enforce negative covenants of the debtor, *In the Matter of Continental Vending Machine Corp.*, (E.D.N.Y. 63-B663). There a settlement between the reorganization trustee and the indenture trustee, reached without litigation of the standing problem, was incorporated in the plan of reorganization. See Trustee's Report pursuant to section 167(5) of the Bankruptcy Act at 38-39 and discussion in SEC, 36th Annual Report (1970) 187. And see also *In the Matter of Dilbert's Leasing & Development Corp.*, (E.D.N.Y. 63-B-148), in which the Chapter X trustee settled an action he had commenced against the indenture trustee, the proceeds to be held for the debenture holders.

The question of a Chapter X trustee's standing to sue on Rule 10b-5 claims on behalf of security holders has been litigated in several cases. In *Mooney* v. *Vitolo*, CCH Bankruptcy Law Reporter ¶ 62,573 (S.D.N.Y. 1967), the trustee was held to have no standing to sue directors and others on behalf of stockholders, for manipulation of the price of the debtor's stock. In *Carpenter* v. *Hall*, 311 F. Supp. 1099 (S.D. Tex. 1970), opinion on mandamus, *sub. nom. Ernst & Ernst* v. *United States District Court*, No. 30,097 (5th Cir. February 25, 1971), however, the district court found standing in an action based on Rule 10b-5 on the ground that the trustee, having settled certain claims against the debtor, became vested with the injured parties' rights by the state

law doctrine of indemnity. He was therefore a member of the injured class and a proper plaintiff to prosecute a class action on their behalf.

The decisions in *Mooney* and *Carpenter* were reached on the simple test of whether the Chapter X trustee himself owns a claim of the same nature as the claims of the class he seeks to represent. If so, he is a proper plaintiff under Rule 23 of the Federal Rules of Civil Procedure.[4] Such a rule is eminently reasonable for class actions brought by private parties, but where it is used to determine the standing of a Chapter X trustee, it becomes a sterile test. At the heart of all standing requirements is the concern that parties are adequately represented so that issues are clearly presented, *Flast* v. *Cohen*, 392 U.S. 83, 99-100 (1968). It is now well established that an organization may represent its members, *NAACP* v. *Alabama*, 357 U.S. 449, 458-459 (1958); *Curran* v. *Laird*, 420 F.2d 123 (D.C. Cir. 1969); *National Student Association* v. *Hershey*, 412 F.2d 1103, 1119-1121 (D.C. Cir. 1969). From the foregoing it follows that the major prerequisite of standing is met if the plaintiff demonstrates a sufficiently genuine interest in the issue to insure that the persons he represents are fully protected. This is certainly true of a reorganization trustee.

The Court below, finding no express authority in Chapter X permitting a reorganization trustee to prosecute claims against an indenture trustee, concluded that none existed. It searched the statute and found power in the trustee to act only in relation to "property" of the debtor. It rejected the argument that claims of debenture holders could be asserted by the Chapter X trustee as a counterclaim to an indenture trustee's account, despite the unqualified statutory power granted by section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an indenture trustee to account.

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[4] Even this mechanical rule was rejected in *Arnold* v. *Greene*, No. C-782 (D. Colo. 1970), interlocutory appeal denied, Misc. No. 506 (10th Cir. 1970), where the Chapter X trustee was held to have a claim on his own behalf, but could not represent other claimants.

In doing so, the Court declined to follow the rationale of *In re Solar Manufacturing Corp.*, 200 F.2d 327, 331-332 (3d Cir. 1952), *cert. denied* 345 U.S. 940 (1953). The *Solar* case held that the reorganization court had inherent power to compel an accounting, even absent the statutory grant in section 212, and that the Chapter X trustee had standing to counterclaim on behalf of debenture holders.

The Court below stated that if the petitioner were successful and recovered from Marine Midland, the latter would simply be subrogated to the debenture holders' claims and the estate would be unaffected. This mechanical logic overlooks the fact that Marine Midland can only be liable if it is found to be guilty of serious negligence or willful misconduct. Subrogation, however, is an equitable doctrine, and will not be allowed to a party guilty of inequitable conduct, *American Surety Company* v. *Bethlehem National Bank*, 314 U.S. 314, 317 (1941).

But even if permitted to subrogate after payment to the debenture holders, the indenture trustee would receive only the distribution to which general creditors are entitled. The effect on the reorganization would be substantial: the debenture holders, for practical purposes, would achieve the status of senior creditors. Thus the matter might well have a great effect in the administration of the debtor's estate. And it is not inconceivable that a settlement would be reached in which Marine Midland would waive any right of subrogation. At this stage the possibilities are speculative, but it can hardly be denied that the reorganization may be substantially affected by the prosecution of the claim against Marine Midland, and that is sufficient to confer standing.

The Court below expressed concern that the power sought to be exercised by the petitioner would permit him to settle the claims of debenture holders against third parties, or even partially or totally release such claims. Yet no settlement could be reached by the reorganization trustee without the approval of the reorgani-

zation court after notice to interested parties and upon consideration of the views of the SEC. These safeguards are fully as adequate as those contained in Rule 23 of the Federal Rules of Civil Procedure. As the dissent below pointed out, participation by the SEC is an important reason for permitting these claims to be litigated in the reorganization proceeding rather than in a bondholders' private class action.

The Court below would have permitted the indenture trustee to prosecute these claims on behalf of debenture holders had they involved "property" of the debtor. It did not acknowledge, however, that in such an action the very problem it was concerned about in the instant case would be equally present: the possible right of the indenture trustee to subrogate and the possible settlement of debenture holders' claims without their consent.

Indeed, the rationale of the Court below that these would be standing if the claims were based upon a mishandling by the indenture trustee of the debtor's "property" (in the narrowest sense), might result in a neater doctrine, but would play havoc with the rights of the debenture holders. The bare title to pledged property in which the debtor has no remaining equity provides no sturdier basis for standing than is present in this case. The underlying claims in either situation are for the benefit of a limited class, against an indenture trustee for violation of his trust. To permit the result to turn on whether "property" of the debtor is involved is to adopt as part of Chapter X fine issues of state law where there is no state interest at stake.

This case presents an opportunity for this Court to define the interrelated functions of Chapter X and the Trust Indenture Act, and the protection they afford to the investing public.

B. Review of the judgment below is required to resolve the conflict between circuits and within the Second Circuit.

The Court below found that petitioner lacked standing to assert the claims of debenture holders, relying on *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). *Clarke* was a plenary action by a reorganization trustee in which damages were sought against an indenture trustee. Dismissal of two counts alleging failure to enforce the debtor's covenants in the trust indenture was affirmed.

Clarke, however, is in direct conflict with the decision of the Court of Appeals for the Third Circuit in *In re Solar Manufacturing Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert. denied*, 345 U.S. 940 (1953). The *Solar* case upheld the standing of a Chapter X trustee to assert similar claims of debenture holders against an indenture trustee in counterclaims to the indenture trustee's proof of claim and to its account. Thus the ability of the debenture holders to have their claims prosecuted by a Chapter X trustee against an indenture trustee depends on the fortuitous circumstances of the circuit in which the debtor is being reorganized.

Moreover, as the dissenters below explicitly recognized, *Clarke* is also irreconcilable with the later decision of the Second Circuit in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert. denied* 346 U.S. 835 (1953), in which standing of the successor of a reorganization trustee to assert a similar claim by counterclaiming to the indenture trustee's account was upheld.

The majority below sought to distinguish the *Prudence-Bonds* case and dismissed with a footnote *In re Solar Manufacturing Corp.*, which it also found distinguishable. Petitioner believes the distinctions to be transparently lacking in substance.

In *Clarke* the reorganization trustee had commenced a plenary action against the indenture trustee on behalf of debenture holders. The first and third counts of the

complaint alleged that the indenture trustee had failed to prevent the debtor from engaging in certain transactions which were in violation of "negative pledge covenants of the indenture" 137 F.2d at 800. The Court of Appeals affirmed the dismissal of these counts because the claims were not part of the property of the debtor, but rather belonged to the debenture holders. In addition the Court stated that the reorganization trustee was barred because he had no title to the claims and was not the real party in interest, Rule 17(a) of the Federal Rules of Civil Procedure. Judge Learned Hand dissented vigorously.

The issue arose in a different procedural context in the *Solar* case. There the pertinent claim was that the debtor had sold its Chicago plant and had deposited the $450,000 proceeds in its general deposit account with the indenture trustee. The reorganization trustee claimed the indenture trustee to have been derelict in not earmarking the $450,000 for the debenture holders. The claim was asserted in counterclaims to the indenture trustee's proof of claim and to the indenture trustee's account which it had filed.

The Third Circuit held that the reorganization trustee had standing to prosecute the claims on behalf of the debenture holders. The Court acknowledged the similarity of the claim to the first and third counts of the *Clarke* complaint. It distinguished *Clarke*, however, holding that the summary jurisdiction of the reorganization court with respect to the indenture trustee's proof of claim and account provided a vehicle for adjudication which apparently was lacking in a plenary action, 200 F.2d at 332, n. 6.

The Court below rejected the procedural distinction made by the Third Circuit. Instead it distinguished *Solar* by dignifying as a holding the casual description by the *Solar* Court of the claim as "quasi in rem and for the benefit of the trust" and "for the restoration of trust funds." *Cf.* 200 F.2d at 332 with Appendix to this Petition 17a, note 4. That general description of the claim

had not been used by the *Solar* court itself to distinguish it from *Clarke,* however, and it is clear that the funds were never part of any trust. They were not delivered to the indenture trustee impressed with a trust, but as deposits in a commercial bank account. The only possible basis for recovery was the failure of the indenture trustee to enforce a negative covenant in the indenture.

Promptly on the heels of *Solar* came *Prudence-Bonds.* There the successor to the reorganization trustee (referred to as the "New Company"), in a counterclaim to the indenture trustee's account, asserted claims on behalf of debenture holders. The debtor in *Prudence-Bonds* had assigned three mortgages to the indenture trustee to secure a series of negotiable bonds which were issued to the public. The debtor had also deposited a guaranty, made by another corporation, of the mortgages held as security. One of the mortgagors defaulted, and although the guarantor was solvent at the time, the indenture trustee failed to enforce the guaranty. The guarantor subsequently became insolvent.

Judge Learned Hand, who had dissented strongly in *Clarke,* wrote the opinion on reargument. He acknowledged, 202 F.2d at 559, that there had been no "surrender or release" of trust assets, the touchstone for permitting a representative action under New York law. Judge Hand avoided the issue of whether claims against the indenture trustee passed upon transfer of the bonds by assuming that some of the bondholders at the time the cause of action arose continued to hold their bonds when the petition for reorganization was filed. That being so, the only question was whether they might be represented by the New Company. That depended, he said, upon whether the New Company was a proper party under Rule 17, made applicable to bankruptcy proceedings by General Order 37. An earlier order in the reorganization proceedings had provided that objections by the New Company to the accounts filed by the indenture trus-

tees (of whom there were many, on eighteen separate issues of bonds) should be deemed to have been made for itself and on behalf of bondholders. Judge Hand found this order to be within the authority granted to reorganization courts to effect and carry out plans.

Therefore, by reason of the order, which was within the statutory power of the court, the New Company became a "party authorized by statute" to "sue in his own name" under Rule 17(a), 202 F.2d at 560. Thus the *Prudence-Bonds* court found the claims to be a proper subject for resolution in a Chapter X proceeding, although *Clarke* had held flatly that such claims "have no place in a plan of reorganization," 137 F.2d at 800.

On the merits, the Court in *Prudence-Bonds* found the indenture trustee to be not liable because of exculpatory provisions of the indenture. In reaching this conclusion the court determined that the guaranty was a part of the trust *res*, for the purpose of interpreting the indenture. The majority below grasped at this to distinguish *Prudence-Bonds* from *Clarke*. In *Prudence-Bonds* the finding that the guaranty was part of the res was pertinent only on the merits. But the court below equated "*res*" with "property of the debtor", as to which the Chapter X trustee has unquestioned standing. The fact that property is part of a trust *res* held by an indenture trustee does not make it property of the debtor, and in *Prudence-Bonds* the guaranty was certainly not property of the debtor.

Moreover, the claim in *Prudence-Bonds* was not for surrender or release of the property, whether the debtor's or a third party's, as Judge Hand expressly stated. The claim was based upon the indenture trustee's failure to act to enforce the guaranty. That is exactly the category of claim sought to be prosecuted here.

The court below treated as a separate issue the status of petitioner under Rule 17, Federal Rules of Civil Pro-

cedure. It concluded that in the absence of express statutory authorization for a Chapter X trustee to prosecute such claims, petitioner was not a proper party. It rejected the contention that section 212 of the Bankruptcy Act, 11 U.S.C. § 612, granting power to compel an indenture trustee to account, was sufficient statutory authority to permit a Chapter X trustee to counterclaim to such an account. That was the rationale in *Solar*, and is less tenuous than the theory relied on in *Prudence-Bonds*.[5]

Left unstated by the Court below, as in *Clarke* and *Prudence-Bonds*, is the question whether, in the situation presented, there is any distinction between the issues of standing on the one hand and status under Rule 17 on the other hand. It would appear that a proper party under Rule 17 has standing, as was held in *Prudence-Bonds*, and that any party with standing is a proper party under Rule 17.

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[5] The order of the reorganization court in *Prudence-Bonds* permitted claims of bondholders to be pressed with respect to eighteen series of bonds. In a number of these the indenture trustees had surrendered or released property of the debtor, e.g. *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130 (2d Cir. 1939). It is therefore questionable whether the order was intended to grant any rights to the New Company which its predecessor, the reorganization trustee, did not possess. It is even more questionable whether the court had power to grant the New Company such additional rights. These doctrinal problems would not be present if an accounting were compelled pursuant to Section 212, to which the petitioner could counterclaim. In the present case, following the theory of *Prudence-Bonds*, the order of the District Court authorizing petitioner to prosecute the claims was, if within the Court's power, sufficient to make petitioner a proper party under Rule 17.

CONCLUSION

For the reasons set forth above, a writ of certiorari should issue to review the judgment of the Court of Appeals for the Second Circuit.

Respectfully submitted,

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APPENDIX

Opinion and Order of the District Court granting defendant's motion to dismiss the complaint in the plenary action

McLEAN, D. J.

Defendant has moved pursuant to rules 12(b)(6) and 17(a) to dismiss this action on the grounds that the complaint fails to state a claim and that plaintiff is not the real party in interests.

The complaint may be briefly summarized as follows: Plaintiff is the trustee of Webb & Knapp, Inc. (the Debtor), now in reorganization under Chapter X of the Bankruptcy Act. Defendant is trustee under a trust indenture executed by the Debtor with respect to an issue of 5 per cent debentures of the Debtor due in June 1974. Debentures in the principal amount of $4,298,200 are now outstanding. In the indenture the debtor made certain covenants "for the use and benefit of all the holders of the debentures." One of these provided that the Debtor would not incur certain types of indebtedness unless its tangible assets were twice its liabilities. Prior to the Debtor's bankruptcy, defendant, as indenture trustee, failed to enforce this covenant. Defendant accepted appraisals of the Debtor's property, delivered to it by the Debtor, which were false and fraudulent and which defendant knew or in the exercise of due diligence should have known were false and fraudulent. Defendant failed to prevent the Debtor from incurring additional indebtedness despite the fact that the Debtor's assets were not twice its labilities. As a result, the debenture holders have been damaged in the sum of $4,298,200 (the full face amount of the oustanding debentures). Plaintiff, "on behalf of" the debenture holders, seeks judgment in that amount.

Opinion and Order of the District Court granting defendant's motion to dismiss the complaint in the Plenary Action

The question is whether plaintiff, the Debtor's reorganization trustee, has standing to maintain this action on behalf of the debenture holders. *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), which is squarely in point, answers this question in the negative. The Court of Appeals there held that such a claim against an indenture trustee for failure to enforce a negative covenant made by the Debtor was a claim that is "personal to" the debenture holder. It held that the reorganization trustee had no title to the claim and could not maintain an action on it on behalf of the debenture holders. The order of the district court dismissing the action was affirmed, on the ground that the complaint did not state a claim and that the reorganization trustee was not the real party in interest.

This decision appears to be still the law in this circuit. I do not agree with plaintiff's contention that *Clarke* was overruled, *sub silentio*, by *Prudence-Bonds Corp.* v *State Street Trust Co.*, 202 F. 2d 555 (2d Cir. 1953).

Plaintiff relies on *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert. denied*, 345 U. S. 940 (1953), which reached a contrary result. The court in *Solar* purported to distinguish *Clarke* on the ground that in *Clarke* the reorganization trustee had asserted the claim in a plenary action (as he does in the present case), whereas in *Solar*, the claim was asserted by the reorganization trustee by way of a counterclaim to an account filed by the indenture trustee of its doings as such indenture trustee and to a proof of claim filed by the indenture trustee for its services.

In my opinion, the difference in the form of the proceeding does not require or permit a difference in result on the substantive issue of the standing of the reorganization trustee to seek affirmative relief. Unless the factual situation

in *Solar* can be said to be sufficiently different from that in *Clarke* to justify a distinction between the two cases on the merits, then the decisions in *Solar* and *Clarke* are in conflict.

Defendant argues that there is such a factual difference. This seems to me improbable, but it is unnecessary to decide that question. There is no distinction between *Clarke* and the present case, and if it be assumed that *Clarke* and *Solar* are conflicting, then it is the clear duty of this court to follow *Clarke* as the controlling decision in this circuit.

Plaintiff's contention that *Clarke* is wrong and that the dissenting opinion in that case presents the correct view is an argument which is not open to plaintiff in this court. Similarly, plaintiff's arguments based on matter of policy and upon the legislative history of the Bankruptcy Act are arguments which can properly be made only to the Court of Appeals. Only the Court of Appeals can decide whether or not *Clarke* is to be overruled.

Defendant's motions are granted. This action is dismissed.

So ordered.

Dated: May 20, 1968

EDWARD C. McLEAN
U. S. D. J.

Opinion of the District Court granting the motion to dismiss petitioner's counterclaim and denying motion to strike the petitioner's objection to the proof of claim

McLEAN, D. J.

This motion by Marine Midland Grace Trust Company of New York (Marine Midland) involves the question which was presented by defendant's motion to dismiss the action entitled *Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York,* 67 Civ. 1914, a motion which I have granted by opinion filed today.

Caplin v. *Marine Midland* was a plenary action which the reorganization trustee of the debtor sought to maintain on behalf of debenture holders to recover damages which the debenture holder allegedly suffered by reason of the failure of Marine Midland, as indenture trustee, to enforce a negative covenant made by the debtor for the benefit of the debenture holders. The nature of this covenant is explained in the Caplin opinion. That explanation need not be repeated here.

In the present case the same question has been raised in the Chapter X reorganization proceeding of the debtor. Marine Midland filed a proof of claim in the Chapter X proceeding in the sum of $51,447.55 for compensation for its services as indenture trustee. The reorganization trustee of the debtor subsequently filed an "objection" to this claim. The reorganization trustee took the position that Marine Midland is not entitled to compensation as indenture trustee because it failed to enforce the negative covenant. The allegations of this objection are substantially identical with those of the complaint in the *Caplin* action.

In addition, the reorganization trustee realleged all these allegations as a counterclaim "on behalf of the holders of the outstanding debentures" to recover damages in the sum of $4,298,200 which the debenture holders have alleg-

edly suffered by reason of Marine Midland's failure to enforce the negative covenant.

Marine Midland now moves to dismiss the counterclaim on the same grounds upon which it moved to dismiss the *Caplin* action, *i.e.*, that the counterclaim fails to state a claim and that the reorganization trustee is not the real party in interest, plus the additional ground that the bankruptcy court does not have summary jurisdiction to determine the counterclaim. Marine Midland also moves to strike the objection on the ground that it is "an insufficient defense to Marine Midland's proof of claim."

The motion addressed to the counterclaim must be granted. As is pointed out in the court's opinion dismissing the *Caplin* action, *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943), a decision binding upon this court, held that a reorganization trustee has no standing to maintain a plenary action on behalf of debenture holders to recover damages allegedly sustained by them by reason of the failure of an indenture trustee to enforce a negative covenant made by the debtor for the benefit of the debenture holders. It necessarily follows that the reorganization trustee has no standing to seek precisely the same affirmative relief, on the same grounds, by way of counterclaim. According to *Clarke*, it is the debenture holders, not the reorganization trustee, who own the claim and hence it is only the debenture holders who may sue on it. To the extent that *In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3d Cir. 1952), *cert denied*, 345 U. S. 940 (1953), drew a distinction between enforcing a claim by independent action and enforcing it by counterclaim, I do not feel at liberty to follow that decision.

Opinion of the District Court granting the motion to dismiss Petitioner's counterclaim and denying motion to strike Petitioner's objection to the proof of claim

In view of this conclusion it is unnecessary to consider the separate question as to whether the bankruptcy court has summary jurisdiction over the counterclaim.

The reorganization trustee's "objection," which in substance amounts to an alleged affirmative defense to Marine Midland's proof of claim, presents a different situation. In opposing Marine Midland's claim, the reorganization trustee is acting, not solely on behalf of the debenture holders, but on behalf of all persons interested in the estate. In this instance Marine Midland is not defending itself against a claim asserted against it on behalf of the debenture holders. It is seeking to recover money for itself. The services for which Marine Midland asks compensation were services rendered by it for the benefit of the debenture holders. Marine Midland's claim necessarily presupposes that it has fully performed its obligations to the debenture holders. If it has not, if it has failed to protect their interests in the manner required by the indenture, it would not be entitled to compensation from the debenture holders.

Marine Midland seeks to recover compensation in this instance from the estate, rather than from the debenture holders, because the indenture provides that the debtor will pay the trustee's compensation for its services. But if Marine Midland is not entitled to compensation from the debenture holders because of its nonperformance of its obligations, it follows that it cannot recover from the debtor either. Thus, Marine Midland's alleged nonperformance is a valid defense, on its face, to Marine Midland's claim.

Marine Midland is attempting to enforce its claim against the debtor's estate. The reorganization trustee, who represents the estate, has standing to resist the claim. If its resistance turns out to be successful, all persons interested

Opinion of the District Court granting the motion to dismiss petitioner's counterclaim and denying motion to strike petitioner's objection to the proof of claim

in the estate, not merely the debenture holders, will benefit. *Clarke* does not apply in this situation.

There can be no question, nor does Marine Midland raise any, about the jurisdiction of the bankruptcy court to determine claims against the debtor's estate.

Marine Midland's motion to dismiss the reorganization trustee's counterclaim is granted. Its motion to strike the reorganization trustee's objection is denied.

Settle order on notice.

/s/ EDWARD C. McLEAN
U. S. D. J.

Dated: May 20, 1968

Opinion of the District Court denying petitioner's motion to compel an accounting

McLEAN, D. J.

By order No. 100 dated April 27, 1967, this court granted the application of the trustee of the Debtor to begin a plenary action against Marine Midland Grace Trust Company of New York (Marine Midland), trustee under an indenture relating to 5 per cent debentures of the Debtor due June 1, 1974, to recover damages allegedly sustained by the debenture holders by virtue of Marine Midland's failure to enforce a negative covenant contained in the indenture. The order also authorized the Debtor's trustee to assert the same claim against Marine Midland by way of counterclaim to the claim filed in the reorganization proceeding by Marine Midland for compensation for its services as indenture trustee. The court reserved decision upon a third application made by the Debtor's trustee at that time, an application to require Marine Midland to account to this court for its acts as indenture trustee.

Thereafter the Debtor's trustee began the plenary action, entitled *Mortimer M. Caplin, Trustee in Reorganization of Webb & Knapp, Inc., etc.* v. *The Marine Midland Grace Trust Company of New York*, 67 Civ. 1914. The Debtor's trustee also asserted the same claim by setting up a counterclaim to the proof of claim for compensation filed by Marine Midland in the reorganization proceeding. Marine Midland moved to dismiss both the plenary action and the counterclaim. By opinions dated May 20, 1968, the court has granted those motions on the authority of *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797 (2d Cir. 1943). The court permitted the Debtor's trustee, however, to assert the claim as a defense to Marine Midland's claim for compensation.

This memorandum is devoted to the question as to which decision was previously reserved, *i.e.*, whether Ma-

rine Midland should now be required to account. Assuming that the court has power to make such a direction, the court sees no valid reason for exercising that power at this time.

Marine Midland is still acting as indenture trustee for the debenture holders. It has filed a proof of claim on their behalf in the reorganization proceeding. It has not resigned, nor has it indicated any intention or desire to resign.

There is no claim here that Marine Midland has in any way mishandled any funds which have come into its hands as indenture trustee. The only claim which the Debtor's trustee has asserted against it is that in the years prior to the Debtor's bankruptcy, it failed to enforce the negative covenant in the indenture. It is apparent that the real reason why the Debtor's trustee requests that Marine Midland be required to account is the fact that the Debtor's trustee believes that he might have standing to assert this claim as a counterclaim to an account, even if he has no standing to assert it by a counterclaim to Marine Midland's claim for services or by independent action.

> *See In re Solar Manufacturing Corporation*, 200 F. 2d 327 (3rd Cir. 1952), *cert. denied*, 345 U. S. 940 (1953)

This belief is not well founded, as long as *Clarke* continues to be the law in this circuit. Since the reorganization trustee has no title to the claim of the debenture holders for damages for the nonperformance by Marine Midland of its duty to enforce the negative covenant, the Debtor's trustee, under the *Clarke* rule, may not sue on that claim. It can make no difference that affirmative relief is sought by counterclaim rather than by independent action, or that the counterclaim is interposed to an account rather than to a claim for services. Hence to require an account from

Opinion of the District Court denying petitioner's motion to compel an accounting

Marine Midland would not accomplish the purpose which the Debtor's trustee has in mind.

It is suggested that Marine Midland's personal interest is in conflict with the interest of the debenture holders. This amounts to a claim that Marine Midland should be removed as indenture trustee, although no such relief is requested in the moving papers.

The suggestion of conflict of interest seems to the court to be far-fetched. Marine Midland initiated this Chapter X proceeding. It asserts that it has acted throughout in accordance with its obligations under the indenture. Obviously, there is no conflict between this position and its continued representation of the bondholders. And even if this court should eventually sustain the Debtor's trustee's objection to Marine Midland's claim for compensation on the ground that Marine Midland failed to enforce the negative covenant prior to the Debtor's bankruptcy, it does not necessarily follow that Marine Midland cannot properly represent the debenture holders in the reorganization proceeding. It would be unjust to remove Marine Midland merely because an objection has been made to its conduct prior to the bankruptcy, an objection which as yet has not been proved. The court sees no probability of injury to the bondholders by permitting Marine Midland to continue to represent them in the meantime, at least until that question is resolved.

Accordingly, the Debtor's trustee's motion to compel Marine Midland to account is denied.

Settle order on notice.

Dated: May 22, 1968

EDWARD MCLEAN

U.S.D.J.

Opinion of the Court of Appeals

Before:

LUMBARD, *Chief Judge,*
MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS
and ANDERSON, *Circuit Judges.**

FRIENDLY, *Circuit Judge*:

We have three appeals and a cross-appeal from orders of Judge McLean concerning the reorganization of Webb & Knapp, Inc. under Chapter X of the Bankruptcy Act which is now pending in the District Court for the Southern District of New York. All relate to complaints by the Chapter X Trustee, Mortimer M. Caplin, concerning alleged failure on the part of The Marine Midland Grace Trust Company of New York ("Marine"), trustee under an Indenture whereunder Webb & Knapp issued unsecured debentures now outstanding in the amount of $4,398,200, to enforce certain covenants made by the debtor.[1]

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* Judge Feinberg took no part in the consideration or decision of this case.

[1] The breach concerns mainly, if not indeed solely, Section 3.6 of the Indenture. Webb & Knapp there covenanted that so long as any of the debentures remained outstanding, it would not incur or assume indebtedness resulting from borrowings or from the purchase of real property or interests in real property on which it would be personally liable, or to purchase any real property, or interests in real property, unless on the basis of computations (made as of the last day of the fourth month prior to such transaction) its "consolidated tangible assets" would equal 200% of certain liabilities. In determining "consolidated tangible assets" the Company was authorized, *inter alia,* to rely on and use appraisals made by its officers and approved by the Board of Directors "of real property, of interests in real property . . . or of the controlling stock interest in any corporation the principal assets of which consist of real property or interests in real property." The Company was required to file a certificate of compliance annually with Marine. In addition to such certificates Marine requested, as permitted by the

Marine had filed a proof of claim in the sum of $51,447.55 for services rendered and expenses incurred by it as indenture trustee. The Chapter X Trustee objected to this on the ground of Marine's alleged breach of duty and counterclaimed for damages in the amount of the debentures that remained outstanding. With the authorization of the district court, he also filed a plenary suit seeking the same relief. In addition he moved that Marine be required to file an accounting. Marine moved to dismiss the objections to its proof of claim, the counterclaim and the plenary suit. The judge held that grant of Marine's motions to dismiss the counterclaim and the complaint was required by *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943), but denied its motion to dismiss the objections. He also denied the Trustee's motion to compel Marine to account since there was no allegation that Marine had mishandled any funds which came into its hands as indenture trustee, and the only claim asserted by the Chapter X Trustee was the indenture trustee's alleged failure to enforce the negative covenant, a claim that would stand no better as a counterclaim to an accounting than as a plenary action or as a counterclaim to a proof of claim. Each party appealed from the decisions adverse to it.

After a panel consisting of Judges Moore, Kaufman and Hays had come to the conclusion that *Clarke* should be overruled, the court voted, in accordance with its usual practice in such cases, see e.g. *Indussa Corp.* v. *S.S. Ran-*

Indenture, and received separate officers' certificates stating specifically that Webb & Knapp was not in violation of §23.6. In accordance with § 315 of the Trust Indenture Act of 1939, 15 U.S.C. § 77ooo, § 10.1 of the Indenture required Marine to examine all reports furnished to it but authorized it, in the absence of bad faith, to rely upon certificates or opinions conforming to the requirements of the Indenture. The Chapter X Trustee claims that although the reports for 1959-63 showed asset-liability ratios ranging from a high of 258.30 in 1961 to a low of 200.56 in 1963, Marine should have known that the appraised values were inflated.

org, 377 F.2d 200 (2 Cir. 1967), to consider the appeals *in banc* upon the briefs already filed. A majority of the full court have concluded that *Clarke* was correctly decided and, since this case is admittedly not distinguishable, that the dismissal of the counterclaim and the plenary suit should be affirmed. We are all of the view that the orders denying the Trustee's motion to require Marine to account and refusing to strike his objections to Marine's claim should be affirmed.

Clarke was an action by the Chapter X Trustee of Associated Gas and Electric Company (Ageco) against the Chase National Bank, trustee under an indenture for debenture holders. Broadly speaking the complaint contained two differing sets of counts. The first and third alleged that Chase, in breach of its duties as indenture trustee, had failed to enforce certain covenants against the mortgage or pledge of Ageco's property or its merger into another corporation and sought to recover losses suffered by the debenture holders in consequence. The second count sought recovery of $4,000,000 allegedly received by Chase from Ageco in payment of an indebtedness, though Chase knew the latter was insolvent or in imminent danger of insolvency; the fourth count alleged that Chase had received a preference in respect of $4,249,000 of Ageco debentures owned by Chase, through an unfair exchange with Ageco's subsidiaries of these debentures for securities of greater value, at a time when Chase knew Ageco was insolvent.[2] The court unanimously reversed an order dismissing the second and fourth counts. A majority, with Judge Augustus N. Hand writing for himself and Judge Chase, upheld an order of a different judge dismissing the first and third counts; as to this Judge Learned Hand dissented.

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[2] A fifth count sought to recover $40,000 that had been paid Chase as trustee's fees, which the district court had dismissed with leave to amend; the court dismissed the appeal from this order for lack of appellate jurisdiction, 137 F.2d at 801.

The majority in *Clarke* reasoned that, assuming liability, "we cannot see that the claims for breach of the covenants are any part of the property of the bankrupt or would affect the plan of reorganization"; they were rather claims "of the debenture-holders not derived from the bankrupt's estate but arising through the alleged tortious action of the indenture trustee." 137 F.2d at 800. They cited the earlier decisions in *In re 1775 Broadway Corp.*, 79 F.2d 108 (2 Cir. 1935), that the reorganization court has no jurisdiction to force nonassenting noteholders to release claims against an indenture trustee for misrepresentation in the sale of the notes, since these were not claims against the debtor or its assets or claims that must be settled to bring property into the reorganized company, and in *In re Nine North Church Street, Inc.*, 82 F.2d 186 (2 Cir. 1936), that the reorganization court has no jurisdiction to enjoin nonassenting certificate holders from suing the guarantor of a mortgage on the debtor's property since the suit was to enforce a personal right against the guarantor and did not concern property subject to reorganization. Judge Learned Hand argued that the indenture trustee had a duty to prevent the violation of the covenants in the indenture, 137 F.2d at 802, which was true enough, and then asked "In what way does that [breach of duty] differ from allowing a debtor, in violation of the mortgage, to substitute improper collateral?". The answer was that in the latter case the mortgage trustee would have dealt improperly with property of the bankrupt. Judge L. Hand himself had based his opinion in *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2 Cir. 1939), on the ground that there the accounting dealt with property of the debtor which trustees for secured creditors had allegedly surrendered in breach of the trust, and that the rights of the creditors to compel them to restore the *res* was within the "extended"

concept of the debtor's property in a reorganization.[3] He was there careful, however, to distinguish the case in which the creditors asserted rights having "nothing to do with the *res* and [which] would not restore it" and "had nothing to do with anything that had ever been the debtor's property, or with the distribution of any part of it." *Id.* at 132. This distinction, apparently lost sight of in his dissent in *Clarke,* had been further developed by Judge Frank in *Brooklyn Trust Co.* v. *Kelby,* 134 F.2d 105, 110-12, 116 (2 Cir.), *cert. denied,* 319 U.S. 767 (1943).

A year and a half after *Clarke,* a panel consisting of the three other judges of the court as it then stood, Swan, Clark and Frank, decided the complicated case of *President and Directors of Manhattan Co.* v. *Kelby,* 147 F.2d 465 (2 Cir. 1944), *cert. denied,* 324 U.S. 866 (1945). The unanimous opinion was written by Judge Frank, who had long been expert in reorganization matters and was a member of the SEC when Chapter X was adopted, in no small measure at its instance. The court took a broad view of the rights of reorganization trustees against a trustee under an indenture but stopped when it came to an issue similar to that here presented. One of the claims of the Chapter X Trustees was that the indenture trustee was liable in damages for failing to enforce a covenant of Prudence-Bonds Corporation to deposit a guarantee by the Prudence Company. Although recognizing that such damages might be considerable, the court held that "an action for those damages is not one for restoration of the [trust] fund" and "cannot be maintained in connection with the bankruptcy proceedings," 147 F.2d at 478, citing *Brooklyn Trust Co.* v. *Kelby, supra,* 134 F.2d at 111.

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[3] The "extension" was that in some instances the Chapter X trustee may be able to recover property of the company which the debtor, because it might be barred by a defense of consent or estoppel, could not. See *McCandless* v. *Furland,* 296 U.S. 140, 159-61 (1935).

It is with this background that we come to *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555, 558 (2 Cir.) *cert, denied*, 346 U.S. 835 (1953), more particularly to Judge Learned Hand's opinion on rehearing. The Chapter X Trustee regards this as fundamentally inconsistent with *Clarke*, which the opinion did not mention. In our view the reason for failing to mention *Clarke* was that for grounds clearly stated by Judge Hand, there was no inconsistency.

The holdings in *Prudence-Bonds* with which we are concerned were (1) that the Chapter X Trustees could have maintained an action against an indenture trustee for failure to enforce a "Secondary Guaranty" by the Prudence Company of mortgages held by the indenture trustee as security for the bondholders, and (2) that this right had been conveyed to the reorganized company. Indeed it is only the first holding that is of real interest here. Its justification was thus stated, 202 F.2d at 561:

> But by the Secondary Guaranty the Guarantor became a surety for the performance of the mortgagors, just as the mortgages were a surety for the same performance. The only difference between them was that in one case the security was the promise of a third person and in the other it was a lien upon property. The promise was a part of the *res* in precisely the same sense that the promises were in the policies of fire and title insurance, mentioned in Article 1, §2. As we have said, it was in effect the equivalent of a policy of credit insurance of the mortgagors.

The significance of this was heightened by the distinction drawn between the indenture trustee's failure to enforce the "Secondary Guaranty" and the "Primary Guaranty," i.e., a guarantee by the Prudence Company of the bonds of Prudence-Bonds themselves. While the court said it

"need not answer" the question whether this "was also a part of the *res*," the opinion in effect did so when it said that this "was a promise to pay the Debtor's obligations, and had nothing to do with the *res*." *Id.* It was the Primary Guaranty which was like the claim sought to be pressed in *Clarke* and here.[4] Far from being indistinguishable, as the dissent claims, *Prudence-Bonds* differs from this case and from *Clarke* on the very ground Judge Hand was at such pains to clarify. If Marine had held property of Webb & Knapp through pledge or, for example, as a result of payments into a sinking fund, the Chapter X Trustee could sue under *Prudence-Bonds* for mismanagement of such assets, since he would be asserting a claim to property of the debtor which the indenture trustee had held. Here, as in *Clarke*, he is not. The difference between failure to enforce a third party's guaranty of a mortgage assigned to an indenture trustee or other property held by it as security and failure to enforce a promise by the debtor is the highly significant one that the former has diminished the debtor's estate and the latter has not.

The collapse of the argument of the Chapter X Trustee based on *Prudence-Bonds* does not, of course, mean that we could not overrule *Clarke* if we were convinced that Judges Augustus Hand and Chase had been in error. But we are not.

It is necessary in the first instance to consider what effect a recovery by the Chapter X Trustee would have

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[4] We do not regard *In re Solar Mfg. Corp.*, 200 F.2d 327 (3 Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953), as in conflict with *Clarke*. Although we would not be persuaded by the procedural distinction made at p. 332 n. 6, the counterclaim against the Indenture trustee there sustained was for failure to earmark $450,000 it had received upon the sale of certain of the debtor's property. Since the claim was for failure to keep funds of the debtor which the indenture trustee was bound to hold in trust, the court concluded that the cause of action was "quasi in rem for the benefit of the trust" and "for the restoration of trust funds." *Id.* at 332.

on the reorganization. On a superficial view this might seem substantial—if, for example, the Chapter X Trustee were to achieve a complete recovery, the debenture holders would be paid off and it might seem there would be that much more for the other creditors and the stockholders. But this pleasant prospect speedily evaporates when the law of subrogation is brought into play. As a result of subrogation, Marine would simply be substituted for the debenture holders as the claimant. Cf. ALI, Restatement of Security §141 (1941). If the Chapter X Trustee recovered judgment in a lesser amount, the claim of the debenture holders would still be provable in full, with the division of the proceeds between them and Marine dependent upon the results of the reorganization, and other creditors or stockholders would not be affected. Indeed, even these hypotheticals put the case too favorably for the Chapter X Trustee, since we do not see the answer to Judge A. N. Hand's observation in *Clarke, supra,* 137 F.2d at 800.

> Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants.

The claim against Marine thus could not be prosecuted to judgment until the results of the reorganization become known.[5]

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[5] Caplin argues that failure to allow suit by him would leave the debenture holders without remedy against Marine as a practical matter, since under *Elkind* v. *Chase Nat'l Bank,* 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept.), *aff'd* 284 N.Y. 726 (1940), each would have to sue individually. Apart from other possibilities under F.R. Civ. P. 23, we would not regard it as unlikely that a class action could be maintained in federal court for violation of § 315 of the Trust Indenture Act of 1939, although, of course, we are not to be understood as so deciding.

Equally important to the *Clarke* decision was the necessity, 137 F.2d at 801, under F. R. Civ. P. 17(a), here applicable by virtue of General Order in Bankruptcy 37, that "Every action shall be prosecuted in the name of the real party in interest." To determine whether Caplin has that status, we look to the Bankruptcy Act.

Sections 186 and 187 provide that a Chapter X trustee "shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor." Section 70a vests a trustee appointed under §44 "with the title of the bankrupt" to eight types of property therein described. None of these, by the remotest stretch of language or even of imagination, could include the claims of debenture holders against an indenture trustee for permitting the debtor to violate covenants made by the debtor to the indenture trustee for the bondholders' protection. The bankruptcy trustee's task is to "collect and reduce to money the property of the estates for which they are trustees," §47. While the reorganization trustee's added duty, §167(3), to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate," may be broad enough to authorize him to report whether in his opinion an indenture trustee has failed in its duties to debenture holders and this may assist the latter in asserting their rights, nothing in the statute allows him to collect any moneys or other property not owed to or owned by the estate although, as indicated, see fn. 3, he may sometimes be able to recover an insolvent corporation's property when the corporation itself might be subject to a defense of consent or estopped.

Any other view would, for example, allow a Chapter X Trustee to settle claims of debenture holders against third parties with the approval of the reorganization court, and would, in principle, sanction a plan of reorganization providing for a partial or even total release of such claims. Yet §216(2) says that the plan "may deal with all or any part *of the property of the debtor*" (emphasis supplied) and §216(13) directs that it "may include provisions for settlement or adjustment of *claims belonging to the debtor or to the estate*" (emphasis supplied). The debenture holders' claims against Marine simply do not fit under those rubrics.

The Reorganization Trustee relies heavily on statements from the legislative history of Chapter X, such as that in the House Report, H.R. Rep. 1409, 75th Cong., 1st Sess., pp. 43-44 (1937), that "There must be power and responsibility in the hands of a qualified representative of investors." It was exactly in this spirit that Chapter X was read in its early years by the judges who sat on this court in the 1940's, one of whom, as noted, had played no small role in its enactment. These were not judges who read statutes in the niggling way condemned by Mr. Justice Holmes, "We see what you are driving at, but you have not said it, and therefore we shall go on as before." *Johnson* v. *United States*, 163 F. 30, 32 (1 Cir. 1908). But they could find nothing in Chapter X, as we cannot, to indicate that Congress was "driving at" allowing a trustee to enforce claims not belonging to the estate. Now that the issue has again been raised after so many years, Congress may wish to consider whether it is possible and, if so, desirable to go further and permit the trustee to enforce individual claims of security holders against third parties.[6]

[6] An affirmative answer should not simply be assumed. Apart from possible question whether the bankruptcy power extends to claims of creditors against solvent third parties, which Congress might not think it worthwhile to raise, there would be serious prob-

That is a policy decision to be made by the legislature, not by our overruling soundly reasoned decisions of our distinguished predecessors, who knew the statute every bit as well as we do and construed it to mean what it rather clearly says. We therefore affirm Judge McLean's dismissal of the Chapter X Trustee's counterclaim and plenary suit.

We are all in accord with the decision of the panel to affirm the district court's denial of the Trustee's motion for an accounting. Although §212 gives the reorganization court power to enforce an accounting under instruments whereby anyone of a number of persons, including an indenture trustee "purports to represent any creditor or stockholder," this does not authorize the court to require an "accounting" by an indenture trustee when there is no claim that he holds property belonging to the debtor or any security holder, or has mishandled any such property in the past.

We likewise are in accord with the panel's decision affirming the denial of Marine's motion to strike the Chapter X Trustee's objections to its proof of claim. Marine claims it is entitled to be paid its pro-rata share out of the debtor's property for services it rendered as the indenture trustee, whereas Caplin contends it did not perform the services

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lems if other states have rules like that prevailing in New York before 1950 that transfer of a bond does not carry accrued claims against trustees or guarantors. See *Elkind* v. *Chase Nat'l Bank, supra,* 259 App. Div. 661, 20 N.Y.S.2d 213, *overruled in part by statute,* L. 1950 c. 812 N.Y. Personal Property Law § 41, 4, contrast, *Welch* v. *Northern Bank & Trust Co.,* 100 Wash. 349, 170 P. 1029 (1918), or when such claims had been reserved by agreement. With no showing that the *Clarke* decision had caused any real difficulty over the past twenty-seven years, Congress might well decide that it was best to adhere in the policy of allowing holders of the bonds of debtors in reorganization to pursue their own remedies against third parties.

it should have performed. We cannot say that the objection, if well founded in fact, would not be valid in law. As already indicated, even though the debtor corporation here might have been estopped to assert failure of consideration as a defense to the trustee's claim, as Marine argues, it does not follow that the reorganization trustee may not do so.[7]

The orders of the district court are affirmed. No costs.

KAUFMAN, *Circuit Judge* (with whom Judge Hays concurs), dissenting in part:

I see no justification for continued adherence to the long since eroded rule announced over Judge Learned Hand's vigorous dissent in *Clarke* v. *Chase Nat'l Bank*, 137 F.2d 797 (2 Cir. 1943). I would permit Caplin to assert his counter-claim and maintain the plenary action.

Indeed, Judge Hand himself in effect announced the demise of the *Clarke* rule in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), without saying so expressly. The plaintiff in *Prudence-Bonds*, like Caplin, sought redress on behalf of bondholders for the alleged default by the trustee of a bond indenture. The reorganized corporation, successor to the reorganization trustee and proceeding pursuant to an order of the bankruptcy court, alleged that the indenture trustee had negligently failed to demand payment by a guarantor of a mortgage pledged to the indenture trustee as security for the bonds, following the mortgagee's default. Although at the time of the default and for a period thereafter the guarantor was solvent and presumably could have made good on its guarantee, the guarantor's insolvency followed close upon that of the debtor. Learned Hand, joined by

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[7] We need not consider whether a determination of the objection in favor of the Chapter X Trustee might enure to the benefit of the debenture holders in an action by them under the principle of *Zdanok* v. *Glidden Co.*, 327 F.2d 944 (2 Cir.), *cert. denied*, 377 U.S. 934 (1964).

Chief Judge Swan and Judge Frank, found that the broad authority of the reorganization court to implement a reorganization plan furnished ample authority for the newly reorganized corporation to assert before the bankruptcy court the liability of the indenture trustee "to the bondholders for any loss that resulted" from that trustee's alleged breach. *See* 11 U.S.C. §§621-29.

In its brief on appeal, Marine attempted to distinguish *Prudence-Bonds* in several respects, but each is inconsequential. The relevance of the assertion that Marine successfully opposed Caplin's application for an accounting by Marine or that Marine is not now seeking a release as trustee, escapes me altogether. Such considerations would seem to bear more on jurisdiction than standing. And the claim that the bondholders' interests here are unsecured, unlike those in *Prudence-Bonds*, is also of no moment. Moreover, I would not attribute to Congress the perverse purpose of permitting a bankruptcy court to authorize a corporation already reorganized to assert bondholders' claims against the indenture trustee, as in *Prudence-Bonds*, while denying it the power to dispose of those claims in more orderly fashion by permitting the trustee to raise them *before* the reorganization plan has jelled.

The majority concedes that *Prudence-Bonds* is indistinguishable in any of these respects, but suggests that it may be explained away on yet another ground. The opinion tells us that a Chapter X trustee may proceed against an indenture trustee for failure to enforce a guaranty *by a third party* that secures the trust res, as in *Prudence-Bonds*, but not for failure to enforce a promise *by the debtor himself* contained in the trust indenture, as here, which also protects and secures the trust res. This anomalous result is said to be forced upon us because of language in Learned Hand's *Prudence-Bonds* opinion having nothing to do with that court's discussion of the standing problem.

But when a hypothesis as to a law's meaning is seen to yield such awkward conclusions, it is perhaps better to re-examine the hypothesis than to ascribe to Congress an intent to fashion so irrational a design. In this instance, the pressure to ascribe such an intent is very slight indeed. For in purporting to set forth the reasoning of the *Prudence-Bonds* court with respect to the standing problem, 202 F.2d 555 at 560, the majority relies entirely on dictum which occurs in the court's later analysis of the merits of the successor corporation's action against the trustee. 202 F.2d at 561. The finding of standing in *Prudence-Bonds* is not premised at all on this dictum, but rather "on the broad implementary powers of a judge when a plan is confirmed" and specifically on an order of the reorganization court permitting the new corporation to pursue "*any* objections" (emphasis added) to the indenture trustee's accounts "on its own behalf and on behalf of" the bondholders. There is no basis in the *Prudence-Bonds* opinion for limiting this language, which clearly would comprehend such an action as Caplin's, by transposing into the court's discussion of standing later dictum intended to bear—and even then incidentally and by way of speculation and musing—only on the merits of the new corporation's action, and not on its right to bring it.

In distinguishing *Prudence-Bonds* the majority is compelled to rely on dictum in the opinion irrelevant to the question presently before this court. But, we can understand this, for otherwise the majority would be required to show in detail why there should have been standing in *Prudence-Bonds* under the rationales that it advances to support its decision today. My brothers rightly conclude, and no one has asserted otherwise, that Caplin's claim against Marine could not "by the remotest stretch of language or even of imagination" be considered an action to "collect and reduce to money the property of the [estate] for which" Caplin is trustee, citing Section 47 of the

Bankruptcy Act. But it requires no lesser feat of linguistic gyration to conclude that the action in *Prudence-Bonds* was such an action. The action in *Prudence-Bonds* was one for an accounting for the loss to the bondholders, on behalf of the bondholders alone, that resulted from the indenture trustee's breach of a negative covenant, as here. It was not in any sense an action for restoration of the trust fund or the debtor's property (unless Caplin's action may also be so described). Indeed L. Hand specifically observed that "the breach was at most a failure properly to protect a part of the *res*"—which is precisely the situation here—"and not a 'surrender or release' " of the res. 202 F.2d at 559.

This is not the end of the majority's difficulties with *Prudence-Bonds*. My brothers go to great lengths to show —wrongly, I believe—that "other creditors or stockholders would not be affected" by Caplin's action in this case. But the reorganization in *Prudence-Bonds* has already been effected and would not likely to be altered retrospectively. Even had the suit been brought before a plan had been approved, the recovery would have inured to the benefit of no one but the bondholders, as is the case here.

There is a more fundamental answer, however, to the argument that only one class of creditors will be affected if Caplin recovers. Although the bondholders' recovery will swell directly only the purses of the bondholders, the majority ignores the central consideration that certainty as to the bondholders' rights against the indenture trustee cannot fail to affect the views of the interested parties and the court in passing on the fairness of the reorganization plan. 11 U.S.C. §621(2). The majority thus seems to misconstrue the true scope and nature of a reorganization proceeding. The process of reorganizing is not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed for-

mulas. Rather, the objective is carried out through a process of negotiation, and some give-and-take, in an attempt to adjust equitably and with sensitivity to the nuances of the individual case the rights of competing interested parties. As Judge L. Hand argued persuasively in dissenting from the decision in *Clarke*, the reorganization court has jurisdiction over a case such as this as part of its obligation to "adjust the mutual rights of the debtor's creditors as between themselves." 137 F.2d at 802. I see no reason for denying to the reorganization court, as the majority does, the power to discharge this obligation here or properly to perform its duty to adjudge the equitableness of a proposed reorganization plan.

This latter consideration is particularly relevant to this case, where it appears that the indenture trustee may be implicated in the causes for Webb & Knapp's bankruptcy. As Judge Hand put it, "the trustee should have prevented the debtor from siphoning its assets away from its creditors—the bondholders along with the other general creditors. . . . The loss was . . . of the debtor's assets; the remedy will be in their restoration; I do not understand how that can be alien to a reorganization." 137 F.2d at 802.

Thus, the parade of horribles which my brothers assert would follow if Caplin were allowed to bring this claim —including virtually the confiscation of property of parties with no semblance of due process—is a phantasm. We are concerned here only with the standing of a trustee in reorganization to *assert* the claims of creditors, not to *cancel* them, where the reorganization trustee asserts that creditors have been damaged along with all other parties to the reorganization by the indenture trustee's negligent failure to protect the debtor's assets. It is a very narrow proposition that the majority rejects, not an infinitely expandable one. By rejecting it, the majority retreats from this court's previously declared commitment to the flexible approach announced in *Prudence-Bonds*.

Moreover, the view of the majority appears significantly narrower than that of the *Clarke* majority. That court was unwilling to constrict itself to the narrow "property" analysis advanced by the majority, but suggested instead that the indenture trustee might have standing if "the claims for breach of the covenants [were] any part of the property of the bankrupt *or* would affect the plan of reorganization." (Emphasis added.) 137 F.2d at 800. Immediately following this sentence, the *Clarke* court launched upon an extended discussion of the question whether the claim would affect the plan after which it appended, almost as an afterthought, the observation that "Moreover the trustee . . . has no title to the claims embraced in the first and third counts . . . ." Although I believe that the *Clarke* majority was in error to hold that the claim would not affect the plan, its analysis was considerably broader than that adopted by my brothers.

Finally, the result today ill serves two reforms central to the scheme of the Chandler Act: to promote the collection and dissemination of all information relevant to the debtor and its affairs and to involve the Securities and Exchange Commission in complex reorganization proceedings as an advisor or friend of the court, a role it has assumed as a party to this appeal, in urging us to permit Caplin to pursue his claims. See H. Report No. 1409 on H.R. 8046, 75th Cong., 1st Sess., 47-48 (1937).

The reorganization trustee is empowered to undertake a comprehensive investigation into the history and financial condition of the debtor by 11 U.S.C. §567. To compel the bondholders in these circumstances to proceed individually or in a separate class action, would only give rise to a massive redundancy of fact-finding. To restate the point somewhat more positively, a fair adjudication of the issue between the bondholders and Marine will be promoted if

the information available to the trustee is efficiently brought to bear in that dispute and revealed to the court.[1]

Scrutiny or active participation by the SEC is provided for by numerous provisions of Chapter X (11 U.S.C. §§561, 567(5), 571-74, 590, 608, 622). On few issues is that agency's expertise more relevant than in a case such as this, involving the adjudication of rights and duties of a trustee functioning under the Trust Indenture Act of 1939, 15 U.S.C. §§77aaa *et seq.* This expertise will be available in a reorganization proceeding but ordinarily not in individual or class action bondholders' suits.

In short, today's decision not only retreats from past precedent but is contrary to the purposes which motivated Congress to enact the Chandler Act.

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[1] The manifest inconvenience of the *Clarke* rule is magnified in a case where, as here, the indenture trustee filed a claim against the estate of the debtor for his services as trustee. A determination of the merits of Caplin's plenary action and counter-claim will not require the bankruptcy court to investigate any matters that it would not have to pass upon in adjudicating Caplin's objection to Marine's claim.

Statutes Involved

Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, provides in part:

> "The judge may examine and disregard any provision of a * * * trust indenture * * * or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder * * *."

The Trust Indenture Act of 1939, 15 U.S.C. §§77aaa *et seq.*, provides in pertinent part:

> § 77bbb. Necessity for regulation
>
> (a) Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress pursuant to section 78jj of this title and otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected—
>
> (1) when the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors, notwithstanding the fact that (A) individual action by such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;
>
> (2) when the trustee does not have adequate rights and powers, or adequate duties and re-

sponsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures (A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and (B) generally relieve the trustee from liability even for its own negligent action or failure to act;

(b) Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public; and it is declared to be the policy of this subchapter, in accordance with which policy all the provisions of this subchapter shall be interpreted, to meet the problems and eliminate the practices, enumerated in this section, connected with such public offerings. May 27, 1933, c. 38, Title III, § 302, as added Aug. 3, 1939, c. 411, 53 Stat. 1150.

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§ 77ooo. Duties and responsibility of the trustee—Duties prior to default

(a) The indenture to be qualified may provide, that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn of this title to determine whether or not such evidence conforms to the requirements of the indenture.

* * * *

Responsibility of the Trustee

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts; and

* * * *

§ 77vvv. Court review of orders; jurisdiction of offenses and suits

* * * *

(b) Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 77v(a) of this title.

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION[1] IN SUPPORT OF THE PETITION

1. The Securities and Exchange Commission supports the petition of Mortimer M. Caplin, appointed under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, as trustee of Webb & Knapp, Inc., for

[1] The Securities and Exchange Commission is participating in the reorganization proceeding in the district court as a party pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, and has taken positions in that court and in the court of appeals similar to the positions urged herein. As in *Protective Committee* v. *Anderson*, 390 U. S. 414, 420 n. 3, the Commission is "an unnamed respondent before this Court." See Rule 21(4) of the Rules of this Court.

444-748—71

review of the *en banc* holding below that petitioner lacks standing to assert claims on behalf of holders of debentures issued to the public by Webb & Knapp against Marine Midland Grace Trust Company of New York as trustee under the indenture pursuant to which the debentures were issued. It believes that the case presents an important issue in the administration of the corporate reorganization provisions of the Bankruptcy Act that this Court should resolve.

The claims asserted by petitioner against Marine Midland were based on a covenant contained in the indenture for the benefit of the debenture holders which prohibited Webb & Knapp from purchasing real property or incurring certain indebtedness at any time when its consolidated tangible assets were less than 200 percent of certain liabilities (Indenture, Section 3.6; Pet. App. 11a, n. 1). Petitioner alleged that Marine Midland had breached its duty under the indenture to enforce the covenant by not challenging certificates submitted by Webb & Knapp to establish compliance which were based on—and which Marine Midland should have known were based on—grossly inflated appraisals of Webb & Knapp's assets (Pet. App. 11a–12a, n. 1). Petitioner's claims for $4,398,200, the amount of the outstanding debentures (Pet. App. 11a), were asserted in a counterclaim to a claim asserted in the reorganization proceedings by Marine Midland for certain services, and in a plenary suit which the district court had authorized petitioner to file. Petitioner also moved in the reorganization proceeding that Marine Midland be

required to file an accounting to which petitioner intended to assert these claims as a counterclaim (Pet. App. 12a).

The district court, in three separate orders, dismissed the counterclaim[2] and plenary suit and denied the motion for an accounting (Pet. App. 1a, 4a, 8a). On consolidated appeals, the court of appeals, in an *en banc* decision, followed its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (C.A. 2), and affirmed the district court's orders (Pet. App. 11a–22a). Judges Kaufman and Hays dissented (Pet. App. 22a–28a).

2. The decision below seriously restricts the ability of Chapter X trustees to protect the interests of public investors in debtors and equitably to adjust a debtor's affairs and conflicts in principle with the decision of the Third Circuit in *In re Solar Manufacturing Corp.*, 200 F. 2d 327, certiorari denied, 345 U. S. 940.[3] Moreover, several district court cases have dealt with similar issues involving the standing of the Chapter X trustees, reaching inconsistent results (see

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[2] Petitioner was permitted to assert his claims as an affirmative defense to Marine Midland's $51,448 claim for certain services (Pet. App. 6a–7a).

[3] See *In the Matter of Manufacturers Credit Corporation, v. Securities and Exchange Commission*, 395 F. 2d 833, 842 (C.A. 3), where the court, in comparing advantages to public investors to be found in Chapter X against their position in a proceeding under Chapter IX of the Bankrupty Act, noted that action for "* * * potential remedies which the Securities Act of 1933 may afford innocent investors against those from whom they purchased the notes * * * and for others, which may be disclosed by his investigation, can be more effectively prosecuted by a Chapter X trustee than by the individuals concerned."

Pet. 8–9). Accordingly, review by this Court is warranted.

a. In denying petitioner standing, the court below failed to recognize the critical role that Chapter X trustees play in protecting the interests of public investors. As was emphasized in the House Report on what became the Chandler Act, 52 Stat. 883, revising Chapter X (H. Rep. No. 1409, 75th Cong., 1st Sess., p. 43):

> There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest. * * *

The numerous debenture holders in this case are presumably widespread and, at least in New York, face uncertain legal obstacles to the institution of a class action against Marine Midland (see Pet. 5, n. 3). Under these circumstances, petitioner is the only one who can effectively protect the interests of the debenture holders and accordingly should be granted standing to maintain an action on their behalf in the district court.

In holding that petitioner lacks standing to assert the claims of the debenture holders against Marine Midland because the claims did not concern property of Webb & Knapp, the court below emphasized its view that a recovery would benefit only the debenture holders and not the estate as a whole, as Marine Midland—to the extent found liable to the debenture

holders—would merely be subrogated to the debenture holders' claims against the estate (Pet. 17a–18).[4] But, even if other creditors would not benefit as a result of the recovery by the debenture holders, the other creditors would be in no worse position and the debenture holders would be in a better position, since they might receive as much as one hundred cents on the dollar instead of the fraction of that amount which may be distributed in the reorganization.[5] The fate of a substantial body of public creditors—the debenture holders—may be a critical factor in developing a successful reorganization plan, for, as Judge Kaufman pointed out in his dissent (Pet. App. 25a–26a), recovery by the debenture holders could have a substantial effect on the view of interested parties and the courts in considering the fairness of the overall reorganization plan. Thus, the majority's literal reading of Sections 216(2) and (13) of the Bankruptcy Act, 11 U.S.C. 616(2) and (13) (Pet. App. 20a), to deny petitioner standing to protect the debenture holders, unduly confines the scope of the reorganization process.

b. The harsh rule announced in *Clarke* had in effect been ameliorated (before being reaffirmed by the deci-

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[4] This conclusion may be unsound, however, as negligent conduct—such as that alleged here—may bar a party from asserting the equitable doctrine of subrogation. See *German Bank* v. *United States*, 148 U. S. 573; *A. Gusmer, Inc.* v. *McGrath*, 196 F. 2d 860 (C.A.D.C.).

[5] The burden on the estate of litigating the debenture claims would appear to be minimal, for petitioner would have to prove the same facts in his objection to Marine Midlands' proof of claim (see n. 2, *supra*).

sion below) by a subsequent opinion of Judge Learned Hand (who vigorously dissented in *Clarke*) in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (C.A. 2), holding that a Chapter X trustee had standing on behalf of certain bondholders to sue an indenture trustee for failure to pursue a guarantee of a defaulted mortgage pledged by the debtor as collateral for the bonds. In a similar decision, the Third Circuit held in *In re Solar Manufacturing Corp., supra,* that a Chapter X trustee could assert the claims of debenture holders against the indenture trustee for failure to earmark certain funds of the debtor for the debenture holders as required by the indenture.

The court below sought to distinguish both *Prudence-Bonds* and *Solar* on the theory that the Chapter X trustee in each case was asserting a claim to a part of the trust "res."[*] The court conceded that, if Marine Midland had held property of Webb & Knapp through a pledge or as the result of payments into

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[*] In *Prudence-Bonds*, the indenture trustee had had possession of the mortgages pledged by the debtor, and the guaranty to pay defaulted principal and interest on the mortgages was considered as part of the "res." But, as noted in the dissent below (Pet. App. 25a), the action in *Prudence-Bonds*, as here, was one for an accounting for the loss to the bondholders that resulted from the indenture trustee's breach of duty and was not an action for restoration of the trust fund or the debtor's property. Similarly, although the court in *Solar* described the cause of action there as "quasi in rem for the benefit of the trust" and "for the restoration of trust funds," 200 F. 2d at 332, the suit was brought by the Chapter X trustee for the benefit of the debenture holders to whom the indenture trustee owed a fiduciary duty.

a sinking fund, petitioner would have standing to sue (Pet. App. 17a). The above distinctions are, in our view, attenuated and have no basis in logic or policy. In each of the three cases—*Prudence-Bonds, Solar* and the instant case—the Chapter X trustee's primary concern in attempting to sue the indenture trustee was to protect the interests of the public investors; in each case, recovery was sought from the indenture trustee for the benefit of the bondholders. To permit recovery only when the alleged breach of duty can be traced to property which at one time had been in possession of the indenture trustee is to draw an artificial line between groups of investors—protecting those on one side but not the other. The Bankruptcy Act, however, was intended to benefit all classes of creditors. See *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 114.

It is therefore respectfully submitted that the petition for a writ of certiorati should be granted.

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IN THE

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OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

—against—

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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October 20, 1971

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RESPONDENT'S BRIEF IN OPPOSITION

Preliminary Statement

This brief is submitted in opposition to a petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit seeking review of a judgment of that Court which affirmed orders of the United States District Court for the Southern District of New York dismissing a complaint and counterclaim to a proof of claim in bankruptcy, holding that in each instance the petitioner had

failed to state a claim upon which relief could be granted and failed to satisfy the real party in interest requirement of Rule 17(a), Federal Rules of Civil Procedure.

Question Presented

May a trustee in reorganization of a debtor pursuant to Chapter X of the Bankruptcy Act prosecute on behalf of debentureholders a negligence cause of action in which the debtor has no interest, where any recovery admittedly would be paid to debentureholders, not to the debtor, and would not affect any plan of reorganization, and where the debentureholders themselves are prosecuting the very same claims on their own behalf in actions pending in both the federal and the state courts of New York?

Statement of the Case

For only the fourth time since the Trust Indenture Act was passed in 1939, a federal Court of Appeals has considered the question of the standing of a trustee in reorganization to assert claims against an indenture trustee on behalf of a class of debentureholders rather than for the debtor. In a comprehensive opinion synthesizing the three previous holdings, the Court of Appeals for the Second Circuit found, as it had done twenty-eight years previously, that debentureholders, and not the trustee, had standing on the facts presented.

On or about June 1, 1954, Webb & Knapp, Inc. and Marine Midland Grace Trust Company of New York ("Marine Midland"), as indenture trustee, executed an indenture providing for the issuance by Webb & Knapp of 5% Sinking Fund Debentures due June 1, 1974, in the

aggregate principal amount of $8,607,600, of which the principal amount of $4,298,200 remains outstanding.

In the indenture, among other things, Webb & Knapp agreed to a negative covenant that it would not incur or assume certain forms of new indebtedness or purchase interests in real property unless it and its "affiliated group" of companies maintained a specified ratio of certain assets to particular liabilities.

In each of the years between 1954 and 1964, pursuant to the indenture, Webb & Knapp filed an officers' compliance certificate with Marine Midland stating that they had not obtained knowledge of any default by Webb & Knapp under the indenture. In addition, Webb & Knapp filed annual certificates during these years specifically affirming the company's compliance with the negative covenant pertaining to asset/liability ratios. The indenture expressly provided that in the absence of bad faith the Trustee could conclusively rely upon the truth of statements contained in officers' certificates delivered to it.

On May 7, 1965, Marine Midland, as indenture trustee, filed a petition for reorganization against Webb & Knapp. The petitioner herein was appointed trustee in reorganization pursuant to the Bankruptcy Act, 11 U.S.C. §§ 1 *et seq.* Thereafter, the petitioner commenced a plenary action against Marine Midland and, separately, asserted a counterclaim and objection to Marine Midland's proof of claim for its trustee fees, together with a motion to compel an accounting by the bank. All of these asserted that Marine Midland had negligently failed to enforce the negative covenant concerning Webb & Knapp's assets ratio and thereby damaged the debentureholders whose securities remained outstanding in 1964.

Actions based upon the very same facts also are being prosecuted by the debentureholders themselves. One of these, pending in the New York state courts, is maintained by a debentureholder on behalf of himself and "all other present and former holders" and asserts negligence by Marine Midland in failing to enforce the assets/liabilities ratio covenant.

Another, pending in a New York federal district court, has been brought by a debentureholder suing individually, as chairman of a Webb & Knapp debentureholders' "Protective Committee," and on behalf of all purchasers, holders and sellers of the debentures similarly situated. The federal action asserts various claims against Marine Midland and other defendants, including the same claim as that asserted by the petitioner based upon alleged negligent failure by Marine Midland to enforce the negative covenant.

Finally, yet another state action is pending on behalf of a debentureholder in his individual capacity.

No claim is made by either the petitioner trustee, or by the debentureholders in their federal and state court actions, that Marine Midland mishandled or even held any funds or other property whatsoever of the debtor in connection with the indenture. None was ever held by Marine Midland, since the debentures were unsecured.

In the present case, the District Court dismissed the petitioner's plenary action and his counterclaim and motion, holding that the matter of the trustee's lack of standing to sue on rights of action belonging to debentureholders, and not to the debtor in reorganization, had been determined long ago by the Second Circuit in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943).

Two judges of the Court of Appeals panel which initially considered the petitioner's appeal disapproved of the District Court's orders, but since such an outcome would have required the overruling of *Clarke*, the case was referred to the entire court, sitting *en banc*. After careful analysis of the original precedent, and the subsequent authorities which petitioner maintained raised inconsistencies, the Court of Appeals reconciled the holdings in a 5-2 opinion which adhered to the *Clarke* result. *Caplin* v. *Marine Midland Grace Trust Co. of New York*, 439 F. 2d 118 (2d Cir. 1971).

Reasons for Denying the Petition

I. Lacking express statutory authorization to sue, petitioner claims he should be allowed to sue, nevertheless, to protect hypothetically uninformed debentureholders, although both state and federal actions brought by debentureholders in behalf of all present and former holders are pending.

In his petition, which is supported without significant elaboration by the Securities and Exchange Commission, Caplin invites a *de novo* inquiry by this Court into the question of the extent of statutory limitations upon a Chapter X trustee's authority to engage in litigation in support of claims other than those of the bankrupt estate. The petition urges extensive examination of the respective legislative purposes of and the various interrelationships between the Bankruptcy Act and the Trust Indenture Act of 1939.

For a variety of hypothetical reasons, the petitioner contends that he should be found to have standing to maintain the debentureholders' claims based on the indenture trus-

tee's alleged failure to enforce a negative covenant. He argues that the debentureholders themselves might find such actions difficult to prosecute because of their lack of ready access to the debtor's records, and he urges the possibility that they might be unlikely even to realize that a claim for relief existed (Pet. 5).

But these hypotheses advanced in support of the petition plainly ignore the facts of this case, in which representatives of the actual parties allegedly injured—the Webb & Knapp debentureholders themselves—already have brought three separate actions in their own behalf based on the same facts. Although the petitioner asks this Court to determine that a Chapter X trustee is "the logical person" to prosecute volunteer actions for hampered or uninformed debentureholders in the light of legislative intent that such persons receive some appropriate protection of their rights, such a hypothetical question is not properly presented by his own petition.

The petitioner does not contend that Marine Midland has in any way mishandled any assets of the bankrupt estate, nor can he argue that recovery of damages by the debentureholders would affect his ability to devise a plan of reorganization for Webb & Knapp. Instead, he argues essentially that the legislative history of two federal statutes should be read to entitle a Chapter X trustee to use the assets of the estate to serve as a sort of champion of last resort for groups of debentureholders. Since he already has certain information about the bankrupt's affairs, petitioner contends, he is a "logical person" to represent them.

But in view of the purely hypothetical nature of these arguments, no substantial question is presented for deci-

sion by this Court. The issue raised in the petition had been thought so well resolved that it was not ruled upon for fifteen years between the last prior appellate decision and the date this action was filed, and the facts of the present case demonstrate that the long-established doctrine is in accord with practical expectations as well as legislative intentions.

In view of debentureholders' willingness and ability to maintain actions in their own behalf, the hypothetical case posed by the petitioner as an example of a situation requiring redress by this Court simply has not arisen.

II. No conflict exists between Circuits or within any Circuit with respect to the issue presented.

This case involves the only instance during the past fifteen years in which a Chapter X trustee has pressed an attempt to assert claims against an indenture trustee on behalf of a group of debentureholders. After full consideration of the only three other appellate cases ever to deal with the problem—including two which came before the very Court of Appeals which affirmed dismissal of this action—the court *en banc* concluded that all were consistent in their requirement that the petitioner could not maintain an action such as this.

The court below adhered to its prior determination that debentureholders' claims for negligence against an indenture trustee for breach of a negative covenant are not part of the property of the bankrupt corporation and have nothing to do with a Chapter X trustee's proper responsibilities. *Clarke* v. *Chase National Bank, supra.*

The *Clarke* opinion was considered by the Third Circuit when a similar case arose a decade later, *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953). But in that instance, a Chapter X trustee argued that an indenture trustee had negligently failed to keep *funds of the debtor itself* in trust, entitling him to sue "for the restoration of trust funds." *Id.* at 332. The Third Circuit pointedly commented that these facts differed from those present in *Clarke* and noted that its result was perfectly consistent with the Second Circuit's reasoning. *Id.* at 332, n. 6.

In the present case, decided almost two decades later, petitioner argued to the Second Circuit that its own *Clarke* reasoning actually *conflicted* with the Third Circuit's holding. But the court below disagreed, noting instead that it found no distinction other than that dictated by altogether different facts. The Second Circuit expressly affirmed that it also did not regard *Solar* as in conflict with *Clarke*. *Caplin* v. *Marine Midland Grace Trust Co. of New York*, *supra*, 439 F.2d at 122, n. 4.

Thus *both circuits agree* that there is *no conflict* between their holdings.

In addition, petitioner argued below that the *Clarke* rule conflicted with a later holding of the Second Circuit itself

in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir.), *cert. denied*, 346 U.S. 835 (1953).

The *Prudence-Bonds* opinion was written by Judge Learned Hand, who himself had dissented in *Clarke*. Although Judge Hand's opinion does not refer to the earlier *Clarke* case, the Second Circuit examined the two decisions in detail and concluded that the later one did not tacitly overrule *Clarke*. "Far from being indistinguishable" as petitioner had urged, the court below held, "*Prudence-Bonds* differs from this case and from *Clarke* on the very ground Judge Hand was at such pains to clarify." 439 F.2d at 122. (In *Prudence-Bonds*, as in *Solar*, the Chapter X trustee asserted a claim to property belonging to the debtor.)

This reconciliation of any possible difference between its 1943 *Clarke* holding and the 1953 *Prudence-Bonds* decision occurred, as was appropriate, in an *en banc* opinion by the entire Second Circuit. Consequently, there can be no remaining "conflict" within the Second Circuit as petitioner contends.

CONCLUSION

The petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit should be denied.

Respectfully submitted,

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

I

Respondent's brief in opposition relies heavily upon the argument that there is no need to grant standing to the petitioner to assert claims on behalf of debentureholders, as the owners of the securities are willing and able to litigate their own claims. To prove the proposition, respondent points to three unidentified actions commenced by holders of Webb & Knapp, Inc. debentures "based upon the very same facts" as those alleged by petitioner (Brief in Opposition, p. 4.

Unquestionably individual debentureholders themselves have standing to prosecute their own claims, but that is beside the point. There are many situations where numerous

persons have standing to sue, and do so. However, petitioner clearly is in a better position to prosecute effectively the claims of *all* the debentureholders than are the individual debentureholders themselves. Rather than discuss the merits of the propposition, respondent attempts to brush it aside by characterizing it as "hypothetical" (Brief in Opposition 5, 6). The issue is far from hypothetical, as evidenced by this very case.

The matter which cries for the decision of this Court relates to the *power* of a reorganization trustee. This question cannot be determined on the peculiar facts, or nuances of state law relating to representative actions, involved in any particular case. Thus respondent's recital of three pending actions brought by Webb & Knapp debentureholders is not significant. But because respondent stresses those actions in its brief, without describing them, the Court should be apprised of a few pertinent details.

One action, as respondent states, is an action by a debentureholder suing in his individual capacity. Not being a class action, it will benefit no one but the individual plaintiff, if he is successful.

Another action is *Ray* v. *Marine Midland Grace Trust Co.*, New York Supreme Court, New York County, Index No. 2159-1967. As stated in the Petition at page 5, note 3, an appeal is pending in that case on the question of whether, under New York law, a class action will lie on the facts pleaded. As the index number indicates, it was commenced in 1967, but it is still in the pleading stages without final resolution of its status as a class action.

The third case is *Lewis* v. *Marine Midland Grace Trust Co.*, U. S. Dist. Ct., S.D.N.Y., Docket No. 68 Civ. 1764. Although one count of the amended complaint in that action is indeed based on the same facts as the instant case, the claim is pleaded on a very different theory: it seeks relief under section 10(b) of the Securities Exchange Act of 1934

and Rule 10b-5 promulgated thereunder, 17 CFR § 240.10b-5: Whether a Rule 10b-5 action can be maintained is open to question, as indicated by the fact, not mentioned by respondent, that a motion (in which respondent is one of the moving parties) to dismiss the complaint is pending. Even if the complaint is upheld, there will remain open the question as to whether all, or merely some, of the debentureholders will benefit from any judgment which might ultimately be recovered. Pre-trial depositions and discovery have not yet commenced in that action which is now more than three years old.

Thus the three actions which respondent say demonstrate that there is no policy served by permitting petitioner to have standing, in reality establish exactly the opposite.

The issue, however, is not whether one or three or ten actions have been commenced by debentureholders, or whether such actions are adequate to protect the rights of the entire class. The instant case and the Webb & Knapp reorganization proceedings arose in New York, where it is most likely that aggrieved debentureholders will act, with the aid of an aggressive bar, to protect their own interests. But many reorganization proceedings are administered in parts of the country where security holders and counsel may be less knowledgable. The question to be decided must be considered in terms of Chapter X reorganizations in general—not simply on the basis of the Webb & Knapp proceeding.

These policy considerations, which we believe respondent has incorrectly analyzed, undoubtedly merit attention. They are not, however, the only, or even the most important factors. Petitioner's contention is that a reorganization Trustee has standing in any event. Regardless of any other procedures available to the debentureholders, a reorganization Trustee has the power, granted by the Chandler Act, to assert their claims against an indenture trustee.

II

Respondent also notes that the issue presented here has been considered by Courts of Appeal only four times since the enactment of the Trust Indenture Act of 1939. This is no indication that the question is unimportant. It is as likely that reorganization trustees have been deterred from instituting actions against indenture trustees by the restrictive doctrine of *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943). The absence of reported opinions of Courts of Appeal does not mean that the issue arises only rarely. As the Petition shows, at pages 4-5, the question of reorganization trustees' standing arises with substantial frequency.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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IN THE

Supreme Court of the United States

October Term, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc., etc.,

Petitioner,

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

Opinions Below

The opinions of the District Court (58a, 62a, 67a) have not been reported. The majority and dissenting opinions of the Court of Appeals, *in banc* (84a, 96a), are reported at 439 F.2d 118 (2d Cir. 1971).

Jurisdiction

The judgment of the Court of Appeals (82a) was entered on March 3, 1971. The petition for a writ of certiorari was filed May 29, 1971, and was granted December 7, 1971. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

Question Presented

Whether the trustee in reorganization of a debtor under Chapter X of the Bankruptcy Act is barred, as lacking standing, or not being the real party in interest, from bringing a suit or prosecuting a claim on behalf of the debtor's debenture holders against the indenture trustee for willful misconduct or gross negligence in failing to enforce covenants in the trust indenture.

Statutes Involved

Relevant portions of the Bankruptcy Act and the Trust Indenture Act of 1939 are set forth in Appendix A, *infra*, pp. 35-39.

Statement of the Case

Petitioner Mortimer M. Caplin, trustee in the bankruptcy reorganization of Webb & Knapp, Inc. (the "Debtor"), seeks damages on behalf of the Debtor's debenture holders from respondent indenture trustee, The Marine Midland Grace Trust Company of New York ("Marine"). Petitioner Caplin (the "Trustee") charges that the losses suffered by the debenture holders are attributable to Marine's willful misconduct or gross negligence. The District Court held that the Trustee has no standing to assert the claims of debenture holders against Marine and further that he is not the real party in interest. A divided Second Circuit, sitting *in banc*, affirmed. The Trustee seeks reversal of that order so that he can, on remand, litigate the merits of his charges against Marine.

The petition seeking the reorganization of the Debtor under Chapter X of the Bankruptcy Act was filed by

Marine itself on May 7, 1965. The Securities and Exchange Commission ("SEC") intervened on May 10, 1965. It has participated throughout and supports the Trustee in this action. The Trustee was appointed on May 18, 1965. Pursuant to sections 21a and 167 of the Bankruptcy Act, the Trustee intensively investigated all of the Debtor's affairs. He found that appraisals and certifications submitted annually by the Debtor to Marine were false and fraudulent.

These appraisals and certificates were crucial. Section 3.11 of the trust indenture (the "Indenture") (31a), required the Debtor to certify annually in writing to Marine that it had not defaulted under the Indenture. Marine, year after year, accepted the certifications and inflated appraisals without question, even after the occurrence of other defaults under the Indenture which should have alerted it to the Debtor's precarious condition (40a). Marine either knew that the appraisals were inflated and willfully disregarded them or was grossly negligent in failing to recognize their falsity.

The crucial nature of the appraisals and certificates is apparent from a reading of section 3.6 of the trust indenture, which prohibited the Debtor from purchasing real property or incurring additional indebtedness unless it maintained a ratio of assets to liabilities of 200% (31a). The Trustee claims that the appraisals of real assets which the Debtor submitted to Marine in order to demonstrate that it was maintaining the required ratio were false and fraudulent, as Marine knew or should have known. In fact, at no time between 1958 and 1965 did the Debtor maintain the required ratio, and its excessive overstatements of real assets were apparent on their face. For example, a parcel of land in Bronx County, New York, on

which no significant improvements were made, was appraised and reappraised as follows (34a-35a):

Year	Net Book Value	Appraisal
1957	$2,885,000	$15,000,000
1958	2,918,000	27,500,000
1959	4,182,000	64,000,000
1960	5,952,000	64,000,000
1963	4,168,000	91,530,000[1]

These false appraisals, which Marine wrongfully did not question, lay at the core of the Debtor's collapse, for even with them it was barely able to show that the stipulated ratio was being maintained (33a):

Year	Ratio
1959	201.35%
1960	216.88%
1961	258.30%
1962	206.90%
1963	200.56%

Moreover the Debtor affixed a note to the appraisals for the years commencing 1958 which stated that they represented the officers' "view as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established" (37a). The Trustee contends that this footnote put Marine on notice that the appraisals did not comply with the Indenture and were inflated, and that Marine,

[1] The parcel was not included in the 1961 and 1962 appraisals because it had been conveyed to an affiliated corporation. In 1963 it was conveyed to another corporation in which the Debtor had an 80% interest. Thus the 1963 appraisal of $91,530,000 represents only 80% of the property interest shown on the 1960 appraisal (35a).

however, took no action to compel the Debtor to comply with the Indenture.

In short, the charge which the Trustee seeks an opportunity to litigate is that Marine's gross negligence or willful misconduct permitted the Debtor to continue for many years an unchecked and disastrous course of real property purchases and additional borrowings in hundreds of transactions involving tens of millions of dollars—a course which led inexorably to default on the debentures and bankruptcy.

With authorization from the Reorganization Court, the Trustee commenced a plenary action against Marine for $4,298,200, the face amount of the defaulted debentures, and filed objections and a counterclaim to the proof of claim submitted by Marine in the reorganization proceeding.[2] The District Court dismissed the Trustee's counterclaim and his complaint in the plenary action. The court also denied the Trustee's petition to direct an accounting by Marine, but denied Marine's motion to strike the Trustee's objection to Marine's proof of claim. The District Judge concluded that under the decision in *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), the Trustee had no standing to sue and that *Clarke* had not been overruled by *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert. denied* 346 U.S. 835, as the Trustee had asserted.

Two of the three judges before whom oral argument was had in the Second Circuit would have reversed the District Court and permitted the Trustee to prosecute the claims against Marine, but, pursuant to its procedure,[3] the

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[2] With court authorization the Trustee also sued the Debtor's directors for waste and mismanagement. A favorable settlement of this suit has been reached and has been approved by the Reorganization Court.

[3] This is established practice in the Second Circuit where a three-judge panel would overrule a prior decision. *See, e.g., Indussa Corp.* v. *S. S. Ranborg*, 377 F.2d 200 (2d Cir. 1967).

Court of Appeals reviewed the appeal *in banc*, without hearing oral argument, and affirmed the District Court decision, two judges dissenting. Emphasizing that the Trustee was asserting rights of the debenture holders rather than of the bankrupt estate, the majority concluded that the Trustee's suit, even if successful, would not have a substantial effect on the plan of reorganization. Since the majority decided to reaffirm the rule of *Clarke*, that a reorganization trustee can only pursue claims which are "part of the property of the bankrupt or would affect the plan of reorganization," 137 F.2d at 800, it held that the Trustee lacked standing. Further, the majority found that the Trustee was not the real party in interest under Rule 17(a) of the Federal Rules of Civil Procedure, for "nothing in the statute allows him to collect any monies or other property not owed to or owned by the estate . . ." (93a)

Judge Kaufman, writing for himself and Judge Hays in dissent, argued that Judge Learned Hand, a vigorous dissenter in *Clarke*, had *sub silentio* overruled that decision in *Prudence-Bonds*. Judge Kaufman further stressed that a reorganization trustee does not lack standing to sue merely because his lawsuit would benefit some but not all of the creditors, and that any lawsuit substantially benefiting a significant class of creditors will inevitably affect the overall plan of reorganization. He pointed out that as a practical matter claims such as that asserted by the Trustee here may not be pursued adequately unless presented within the context of the reorganization.

The dissenters also asserted that the result of the majority decision was to frustrate two reforms central to the Chandler Act: to promote and disseminate information relevant to the Debtor and to involve the SEC as advisor to the reorganization, *i.e.*, that by the majority's imposition of inflexible criteria upon the bringing of actions and asserting of counterclaims as a part of the reorganization proceeding, the proper use of evidence obtained by the

reorganization trustee's investigations is frustrated, and its utilization under the supervision of the SEC is thwarted (101a-102a).

Summary of Argument

The standing of a Chapter X trustee stems directly from the underlying purpose of the Chandler Act and the Trust Indenture Act of 1939. The Chandler Act was enacted primarily to protect public investors, and its chief innovations were the provisions for an independent trustee, to act as a representative of investors, and direct participation by the SEC. Recognizing the overwhelming difficulties faced by individual debt investors in protecting their own interests, the Trust Indenture Act provided that their interests should be overseen by indenture trustees, and imposed minimum standards of conduct for the performance of those duties.

When an indenture trustee is guilty of violating its fiduciary duties, with resulting injury to bondholders, the latter's rights under the Trust Indenture Act are not likely to be redressed unless they can act through a representative. The reorganization trustee is the only person who can be relied upon to uncover hidden wrongdoing and effectively prosecute claims. His possession of the debtor's records, his broad investigatory powers, his functioning under court supervision with SEC participation, uniquely qualify him to act for the large number of injured bondholders, who may well be impotent acting alone. Where there is such a compelling need to give effect to remedial legislation, a right of action is implied, as it has been with respect to other statutes which make up the federal securities laws.

The Court below erroneously reaffirmed *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), which held

that a Chapter X trustee may sue an indenture trustee on behalf of debt investors only if the defendant improperly dealt with property of the debtor or if the claim would affect the plan of reorganization. *Clarke* imports into reorganization proceedings narrow notions of property law which unduly restrict the broad scope of reorganizations under the Bankruptcy Act. In so holding, the Court below refused to recognize its own liberalization of the powers of a Chapter X trustee in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir. 1953), *cert denied*, 346 U.S. 835 (1953). It rejected the salutary approach taken by the Third Circuit in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert denied, sub. nom. Marine-Midland Trust Co.* v. *McGirl*, 345 940 (1953), which found, in the express statutory authority in Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an accounting by an indenture trustee, the right of a Chapter X trustee to counterclaim to such an account.

The Court below erred in failing to recognize that even under *Clarke* a recovery by the Trustee in this case would affect the estate, for obtaining material benefits to an important class of creditors is central to reorganization. In assuming that Marine would simply subrogate to the rights of debenture holders in the event it paid damages to them, the Court below was wrong, and it failed to see that in the give-and-take of the Chapter X proceeding other benefits to the estate were possible.

In concluding that the Trustee is not a real party in interest under Rule 17(a) of the Federal Rules of Civil Procedure, as if it were an entirely different doctrine, the Court below failed to see that criteria for standing and real party in interest are essentially the same, and that Rule 17(a) was intended to be a liberalizing, not a restricting, device.

ARGUMENT

POINT I

Chapter X of the Bankruptcy Act and the Trust Indenture Act confer standing upon a reorganization trustee to prosecute claims on behalf of the debtor's debenture holders based upon the indenture trustee's willful misconduct or gross negligence.

A. Under the Congressional Scheme Regulating Bankruptcy Reorganization Proceedings, the Reorganization Trustee Is Made the Representative of All Investors and Creditors and Is Vested with the Responsibility of Discovering and Enforcing All Claims Arising Out of the Reorganization.

Bankruptcy reorganization proceedings often involve hundreds of claims aggregating millions of dollars presented by a wide diversity of investors and creditors. To insure that all interests receive adequate protection, Congress invested the reorganization trustee with broad powers, to be exercised under the supervision of the court and with the guidance of the SEC, to investigate and enforce all claims of investors and creditors which relate to the reorganization proceedings.

Both Chapter X and the Trust Indenture Act of 1939 resulted from a major study of bankruptcy reorganization procedures made by the SEC at the direction of Congress. This study, and the multi-volume report which derived from it, focused primarily on the plight of public investors in bankruptcy proceedings and spotlighted the need for new means of protecting them. For example, Commissioner (now Justice) Douglas testified as follows:[4]

> "There is . . . widespread and national investor interest in these reorganization proceedings. Cer-

[4] Hearings Before the Committee of the Judiciary, House of Representatives, 75th Congress, 1st Session, on H.R. 6439 subsequently amended and reported as H.R. 8046, June 1-4, 8, 9, 1937, page 163.

tainly in the larger cases the securities are widely held. The holdings are small, and individual action by the security holders, to protect themselves, is, in many cases, out of the question. They either lack the funds, or the skill, the acumen or the initiative to take matters into their own hands. They are frequently without any adequate representation in the proceedings. Even should they desire to organize for mutual protection, they normally will find that the lists of their fellow security holders are not readily available. They are at the mercy of the inside groups—the management and the investment bankers. And the records show that these inside groups frequently have objectives which are incompatible with the objectives of investors. They are interested in concealing claims for fraud or mismanagement; investors are interested in collecting on those claims. . . . The new system which is needed must afford not only a shield but a sword for bona fide investors and their representatives."

Three principal remedies were chosen by Congress. In passing the Chandler Act, which enacted Chapter X, Congress took steps to protect public investors by providing for the participation of the SEC at every stage of reorganization proceedings. See sections 161, 167, 171-174, 179, 190, 208, 222 & 265, 11 U.S.C. §§ 561, 567, 571-574, 579, 590, 608 622 & 665.

More than this was necessary, however, in order to insure that investor's rights would be vigorously defended and enforced, as the House Report on the Chandler Act made clear:[5]

> "It would be idle to provide that protective measures be adopted without likewise providing the means whereby such protection can be afforded. It would be futile to attempt to return these bankrupt estates to their real owners without providing the mechanism whereby the real owners could come into

[5] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 43-44 (emphasis added).

> possession and power. *There must be power and responsibility in the hands of a qualified representative of investors.* Otherwise disorganization may result. *Investors must be afforded a 'focal point' for organization. Such a device as the independent trustee furnishes them with one* in the cases big enough to possess an appreciable investor interest."

In short the Chandler Act not only recognized the need to protect public investors by insuring the participation of the SEC in reorganization proceedings, but took the further, basic step of making the reorganization trustee responsible for actively pursuing their interests. In the words of the Report, the reorganization trustee is to be the "representative of investors." In the words of the Third Circuit, "Congress was determined that the trustee protect the interests of investors as well as those of general unsecured creditors." *In re Solar Mfg. Corp.*, 200 F.2d 327, 333 (3rd Cir. 1952), *cert. denied sub. nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953). The purpose of Chapter X is perhaps best summarized in the words of this Court in *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594, 604 (1965):

> "The aims of Chapter X . . . were to afford greater protection to creditors and stockholders by providing greater judicial control over the entire proceedings and impartial and expert administrative assistance in corporate reorganizations through appointment of a disinterested trustee and the active participation of the SEC."

See also *SEC* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 448-450 (1940); *General Stores Corp.* v. *Shlensky*, 350 U.S. 462, 466-467 (1956).

One year after passing the Chandler Act, the Congress adopted a third remedy designed to protect public investors. By passage of the Trust Indenture Act of 1939, Congress sought to protect investors by imposing minimum fiduciary duties on indenture trustees. Prior to this enact-

ment the protective clauses of trust indentures often proved to be illusory safeguards which merely permitted indenture trustees to immunize themselves from liability for blatant wrongdoing. A classic example is provided by *Hazzard* v. *Chase National Bank*, 159 Misc. 57, 287 N.Y.S. 541 (1936), *aff'd* 257 App. Div. 950, 14 N.Y.S. 2d 147 (1st Dept. 1939), *aff'd* 282 N.Y. 652 (1940), 26 N.E. 2d 801, *cert. denied* 311 U.S. 708 (1940). See generally 2 Loss, Securities Regulation 719-725 (2d ed. 1961). In *Hazzard* the indenture trustee had permitted new securities, valued under false certificates, to be substituted for the collateral which secured the debtor's debentures. Despite proof of this glaring malfeasance, the court was forced by the broad exculpatory provisions of the trust indenture to hold that the indenture trustee was free of liability. Judge Rosenman took the opportunity, however, to point out that the typical corporate indenture "trustee" had few real fiduciary duties and often occupied a position inconsistent with a genuine trust relationship:

> "It is becoming increasingly clear that these indentures, though legally permissible, have all the potentialities of fraud upon innocent investors. A recent study by the Legislature of the State of New York has revealed how widespread has been the damage caused to investors by such debentures . . . and how impossible it has been to secure relief in the courts. . . . This indenture was particularly vicious." 287 N.Y.S. at 570.

It was to remedy these and other abuses that Congress enacted the Trust Indenture Act of 1939. The Act itself recognizes that the "national public interest" requires that there be an indenture trustee for debt securities because individual action by bondholders

> "is rendered impracticable by reason of the disproportionate expense of taking such action, and . . . concerted action by such investors is impeded by reason of the wide disperson of such investors

> through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors." 15 U.S.C. § 77bbb(a)(1).

The statute expressly notes that the provisions of trust indentures generally relieve trustees of liability for negligent acts or omissions. 15 U.S.C. § 77bbb(a)(2).

To deal with these problems the Act provides that all publicly-sold debt securities must be issued pursuant to trust indentures and prohibits the exculpation of an indenture trustee "from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct." 15 U.S.C. § 77ooo(d).

In sum, Congress adopted three remedies to protect public investors: (1) it provided in the Chandler Act that the public interest would be represented by the SEC in all significant bankruptcy reorganizations, (2) it provided in the Chandler Act that the trustee in reorganization should actively represent the interests of investors as well as creditors, and (3) it provided in the Trust Indenture Act that the interests of purchasers of publicly sold debt would be represented by indenture trustees, upon whom the Act imposed significant fiduciary responsibilties.[8]

This case poses the question whether these remedies, adopted by Congress on the recommendation of the SEC, are to be made meaningful by empowering the reorganization trustee to enforce the fiduciary obligations of the indenture trustee.

The enormous value of outstanding debt securities lends added importance to this issue. Between 1961 and 1970, $87 billion worth of debt securities were offered publicly,

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[8] It is noteworthy that both the Chandler Act and the Trust Indenture Act are considered part of the federal scheme of securities regulation. Heuston, Corporate Reorganizations, 38 Col. L. Rev. 1119, 1201-1202 (1938).

$55 billion of this amount was offered between 1967 and 1970, and in 1970 alone the offerings totalled $18 billion. SEC, 36th Annual Report 215 (1970). If reorganization trustees are barred from enforcing the fiduciary responsibilities of indenture trustees, the valuable rights of tens of thousands of debt investors will go unprotected. In order to implement the legislative design to protect the investing public against collusion or wrongdoing by debtors and indenture trustees, reorganization trustees must be afforded standing to enforce the rights of debt investors.

B. A Reorganization Trustee is Authorized Under the Bankruptcy Laws to Sue an Indenture Trustee for Willful Misconduct or Gross Negligence.

The Court of Appeals below felt compelled to rule against the Trustee because it was unable to find specific provision in the literal language of the bankruptcy statutes authorizing reorganization trustees to sue indenture trustees (94a). The Court's approach, however, was as wrong as its conclusion.

In the first instance, it is clear that the Bankruptcy Act directly confers standing on reorganization trustees to sue third-party tortfeasors who are culpably implicated in the bankruptcy. Section 187, 11 U.S.C. § 587, gives reorganization trustees "such additional rights and powers as a receiver in equity would have," and in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), decided before the passage of the Chandler Act, it was established that equity receivers have standing to sue third parties on behalf of bondholders. In *McCandless* the promoters of a corporation and their confederates had purchased bonds issued by the insolvent corporation and then, through the use of fraudulently inflated appraisals of the corporation's assets, resold the bonds to the public at an exorbitant price. The corporation failed, of course, and the Supreme Court, speaking through Mr. Justice Cardozo, held that the receiver in

equity was entitled to sue the promoters to recover their illicit profits for the benefit of bondholders. The substance of the holding is emphasized by the dissent of Mr. Justice Roberts, who felt that the receiver had no standing because the claims were personal to the bondholders. 296 U.S. at 168, 173-174. Since Marine occupies a fiduciary relationship by operation of Congressional enactment rather than under the imprecise principles of general corporate law, it follows *a fortiori* from *McCandless* that the Trustee may sue Marine.

Secondly, even if there were no direct statutory authority, the Trustee would still be empowered to sue Marine, for rights to sue are widely implied under the federal securities laws in order to effectuate the public policies embodied in them. See *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964); *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961). Specifically, there can be no doubt that negligence or willful misconduct on the part of an indenture trustee in enforcing or failing to enforce covenants in a trust indenture is actionable under the Trust Indenture Act, for "the disregard of the command of a statute is a wrongful act and a tort." *Kardon* v. *National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

In fact, the Second Circuit recently held that the SEC can sue under the Securities Exchange Act of 1934 for restitution of illegal profits for the benefit of defrauded investors, despite the lack of specific statutory authorization. *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, — U.S. —, 92 S.Ct. 561 (1971). In so ruling the Court relied upon *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 391 (1970), where this Court emphasized that "[w]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." See also *Superintendent of Insurance* v. *Bankers Life & Casualty*, — U.S. —, 92 S.Ct. 165, 169 (1971), in which this Court recognized

a private right of action under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Rules and Regulations of the SEC.

The policy of liberally interpreting the remedies of the securities laws was clearly stated in *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 433 (1964), where this Court said, with respect to section 14(a) of the Securities Exchange Act of 1934, "that under the circumstances here it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose. * * * 'And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done.'"

The purpose of the Chandler Act requires that it be given the same broad interpretation. This was properly recognized by the Third Circuit:

> "The tendency of judicial interpretation of the Act has been in the direction of progressive liberalization in respect of the operation of the bankruptcy power so as to meet the challenge of present day economic and business conditions. Continental Illinois National Bank & Trust Co. v. Chicago Rock Island & Pacific Ry. Co., 1935, 294 U.S. 648, 675, 676, 55 S.Ct. 595, 79 L.Ed. 1110. Among the powers granted under the Act are *the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto.* The bankruptcy court may invoke its equitable powers to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." [emphasis in original] *In re International Power Securities Corporation*, 170 F.2d 399, 402 (3d Cir. 1948).

Against this background it seems clear that the Trustee has an implicit right to assert claims against Marine on behalf of the debenture holders, for the liability of fiduci-

aries under the Trust Indenture Act is unquestionable, and the policy of that statute and the Chandler Act requires that reorganization trustees be permitted to represent debt investors.

Thirdly, the majority below ruled that a claim by debenture holders could not be asserted by a reorganization trustee as a counterclaim to an indenture trustee's account, despite the unqualified statutory power granted by Section 212 of the Bankruptcy Act, 11 U.S.C. § 612, to compel an indenture trustee to account. In so doing the Second Circuit failed to follow the rule established by *In re Solar Mfg. Corp.*, 200 F.2d 327, 331-332 (3rd Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co. v. McGirl*, 345 U.S. 940 (1953), in which the Third Circuit held that the reorganization court could compel an accounting by an indenture trustee and that in such a proceeding the reorganization trustee has standing to counterclaim on behalf of debenture holders for the misconduct of the indenture trustee.

In short, the remedial purposes of the Chandler Act and the Trust Indenture Act can best be effected, in the context of the facts of this case, by this Court's looking to the flexible and realistic approach of the Third Circuit, reflected in *Solar* and *International Power Securities, supra*, rather than the Second Circuit's "niggling" and unrealistic reading of the statutes involved.

C. As a Practical Matter, Only a Reorganization Trustee Can and Will Adequately Enforce the Rights of Debt Investors.

The reorganization trustee is in a far better position than debt investors to discover, prosecute and prove claims based on the indenture trustee's failure to enforce covenants in the trust indenture. The reorganization trustee has possession of the books and records of the debtor, and, under section 167, 11 U.S.C. § 567, he has the statutory duty

to investigate the affairs of the debtor and report to the court on potential causes of action:

> The trustee . . .
>
> (1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge; [and]. . . .
>
> (3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any cause of action available to the estate.

In making his investigation and report under section 167, the reorganization trustee can retain accountants, lawyers or other professionals, and he has available to him compulsory process for examining witnesses. 11 U.S.C. § 567(2), (4). He functions under the supervision of the reorganization court and with the assistance and participation of the SEC. To be sure, the statutory obligations of the reorganization trustee to investigate the debtor's affairs, and his extraordinary powers and advantages in doing so, place him in the best position to discover the grounds, if any exist, for actions against third parties, and effectively to prosecute all claims based thereon.[7]

By contrast, though individual debt investors are unquestionably entitled to prosecute their own claims, it is doubtful whether they can do so effectively. Not only do they lack access to the debtor's records and power to conduct a meaningful investigation, they also confront the

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[7] Moreover, the reorganization trustee has the benefit of the two-year tolling of the statute of limitations. See section 11(e) of the Bankruptcy Act, 11 U.S.C. § 29(e).

obstacles to effective collective action expressly noted in Section 302(a)(1) of the Trust Indenture Act, 15 U.S.C. § 77bbb(a)(1):

> "... (A) individual action by such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;"

Furthermore, in New York and states which follow its law, debenture holders may be barred from bringing class actions and be relegated instead to individual lawsuits, a most ineffective remedy.[8] In addition, not all reorganization proceedings arise in the great financial centers where a sophisticated and aggressive bar may be available to prosecute claims based on intricate corporate manipulations. In smaller communities potential claims of debenture holders are likely to be overlooked or left unchallenged for lack of resources to prosecute them.

Nor do any practical considerations militate against giving the reorganization trustee standing to sue indenture trustees. No significant additional burden on the estate is involved by permitting the reorganization trustee to sue, for he is required in any event to make a full investigation and report of all potential liabilities. Further, when an indenture trustee has acted improperly the estate will

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[8] *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), aff'd 284 N.Y. 722, 31 N.E. 2d 198 (1940), held that a class action may not be brought with respect to claims against indenture trustees which do not involve a surrender or release of the trust *res*. Whether *Elkind* is still governing law in New York is presently being litigated in cases arising out of the claims involved in the present case. See note, p. 21, *infra*.

almost invariably have an action against the officers and directors of the debtor for the acts of corporate waste and mismanagement which the indenture trustee wrongfully failed to prevent. Since the underlying facts in such an action will be virtually identical to those asserted against the indenture trustee and the legal issues undoubtedly will overlap, there would be a net savings in time and resources if the reorganization trustee can prosecute both actions. In the particular case at bar, any additional expense involved in permitting the Trustee to sue Marine is minimized by the fact that he must in any event make a full presentation in proving his objections to Marine's proof of claim. Finally, the Trustee would almost surely be allowed to recover counsel fees and expenses if his suit against Marine were successful. *See, e.g., Kahan* v. *Rosenstiel*, 424 F.2d 161 (3d Cir. 1970) *cert. denied, sub. nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950 (1970).

No groundless or vexatious litigation will result if reorganization trustees are accorded standing to sue third parties on behalf of debt investors. It is customary in the Southern District of New York to require Chapter X trustees to obtain approval of the reorganization court before actions of any kind are commenced, and this appears to be the general practice. *See* 6 Collier on Bankruptcy 1228 fn. 7, 9. In fact, the possibility of a multiplicity of suits or inconsistent judgments will be minimized by permitting reorganization trustees to sue on behalf of debt investors, and orderly and efficient disposition of what potentially could be a proliferation of litigation will be advanced. *Cf. Penn Central Securities Litigation*, M.D.L. Docket No. 56, E.D. Pa. Dec. 6, 1971, BNA Sec. Reg. & L. Rep., No. 134, p. A-12.

Indeed, under the present unsettled state of the law, debenture holders have commenced several different law-

suits against Marine.[9] If it were clear that reorganization trustees have standing to sue, it is not likely that debt investors would sue either individually or as a class, for in virtually all reorganization cases trustees could be relied upon to prosecute vigorously the claims of all debt investors. Further, there is no reason to suppose that procedures similar to those under Rule 23 of the Federal Rules of Civil Procedure would not be followed with the result that notice would be given to all debt investors, together with the opportunity to exclude themselves from the action. In this event the ultimate resolution of the trustee's action would have a significant *res judicata* effect, whether or not the action were successful on the merits.

Finally, there are simple solutions available should individual debenture holders want to sue in addition to the trustee or should it be impossible to locate all debt investors in order to distribute the proceeds of a favorable judgment. For example, in *SEC* v. *Texas Gulf Sulphur*

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[9] In *Ray* v. *Marine Midland Grace Trust Company*, Supreme Court, New York County, Index No. 2159–1967, an appeal is pending on the question of whether a class action will lie on behalf of the Debtor's debenture holders in light of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept. 1940), *aff'd* 284 N.Y. 726, 31 N.E. 2d 198 (1940). In *Lewis* v. *Marine Midland Grace Trust Company*, Supreme Court, New York County, N. Y. Law J. p. 12, col. 2, June 28, 1968, the rule of *Elkind* was followed and an action brought on behalf of the Debtor's debenture holders on the same ground as that asserted by the Trustee was dismissed as a class action, although it remains pending with respect to the individual plaintiffs. Subsequently, the same plaintiff brought another suit in federal court on a different theory. *Lewis* v. *Marine Midland Grace Trust Company*, U.S.D.C., S.D.N.Y., Docket No. 68-Civ.-1764. In this action the plaintiff seeks relief under Rule 10b-5 and section 10(b) of the Securities Exchange Act of 1934 with respect to the facts involved in the instant case. Whether a Rule 10b-5 action can be maintained is open to question, and even if the complaint is upheld the question will remain whether all, or merely some, of the debenture holders will benefit from any judgment ultimately recovered.

Co., 312 F. Supp. 77 (S.D.N.Y. 1970) *affirmed* 446 F.2d 1301 (2d Cir. 1971), *cert. denied* — U.S. —, 92 S. Ct. 561 (1971), where the SEC was permitted to sue on behalf of investors, the defendants were ordered to make restitution of their illegal profits. This money was placed in an interest-bearing escrow account for five years subject to disposition by the court. Injured investors are to be compensated out of this fund and any private judgments independently obtained are likewise to be satisfied out of it. At the end of five years any undistributed money will become the property of the company.

To summarize, this Court long ago established that equity receivers have standing to sue third parties on behalf of debt investors. Reorganization trustees have all the powers of equity receivers, and recognizing the standing of reorganization trustees serves the explicit purpose of the Chandler Act of making them representatives of investors as well as creditors. An indenture trustee is unquestionably liable under the Trust Indenture Act for malfeasance that injures debt investors, and there is ample precedent for implying rights to sue under federal statutes regulating publicly-held securities. Further, the reorganization trustee is in a unique position to discover the claims of debt investors and to enforce them vigorously and expeditiously, and all significant practical considerations militate in favor of giving him standing. Unless this Court reverses the decision below, however, and recognizes the standing of reorganization trustees to litigate claims arising out of and relating to reorganizations, the rights of debt investors will continue to receive tardy and inadequate enforcement.

D. Neither Reason Nor Precedent Supports the Narrow and Hypertechnical Position of the Court Below.

The Second Circuit ruled that the Trustee lacks standing to sue Marine on behalf of the debenture holders because the action does not involve property of the Debtor and

because the lawsuit would not affect the plan of reorganization. The conclusion that some "*res*" must be involved is neither sound nor rational, and the conclusion that the plan of reorganization would not be affected is simply wrong.

In *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943), Judge Augustus Hand conceded that a reorganization trustee could sue an indenture trustee on behalf of debenture holders where the debentures had been secured by property of the debtor, even if the security was worth less than the debt or had been conveyed away. He contended that the result was different, though, where the debentures were unsecured, for then the claims "are personal to the debenture holders and have no place in the plan of reorganization." 137 F. 2d at 800. Judge Learned Hand dissented, for he saw no rational distinction between a case where an indenture trustee, in dereliction of his fiduciary obligation, conveys away the security and one in which, by similar misfeasance, he permits the debtor to siphon off assets which should have remained available to pay off the debentures. "In what way," he demanded, "does that differ from allowing a debtor, in violation of the mortgage, to substitute improper collateral?" *Id.* at 802.

Twenty-eight years later, the Court below supplied this answer: "The answer [is] that in the latter case the mortgage trustee would have dealt improperly with property of the bankrupt." (88a) A proper response to Judge Learned Hand, however, would have answered his question instead of begging it.

The standing of a trustee in reorganization, and ultimately the practical likelihood that the rights of debt investors will be adequately enforced, should not depend upon irrelevant technicalities of property law. If "property" were permitted to be the decisive factor, then niceties of state law would determine the course of proceedings in which a nationwide federal doctrine is peculiarly necessary. The effect on debenture holders is the same whether

the misfeasance of the indenture trustee permitted the debtor to substitute worthless assets for the property pledged to secure the debt or permitted the debtor to squander its assets in violation of the trust indenture. What is fundamental in either case is that the indenture trustee has breached its fiduciary duty to debt investors and that adequate redress can be obtained only if the reorganization trustee is empowered to act.

It has been more than fifty years since Dean Pound observed that, "Wealth, in a commercial age, is made up largely of promises." Pound, Introduction to The Philosophy of Law 113 (Rev. Ed. 1954). Whether debt is secured or unsecured, the basic protection of debt investors lies in the integrity and vigilance of the indenture trustee. The Trust Indenture Act recognized this by imposing inescapable fiduciary obligations on the indenture trustee. Those duties will become practical realities only when the reorganization trustee is authorized to enforce them. It makes no sense instead to rule that the fiduciary promises of an indenture trustee can be counted on only when they can be linked, whether meaningfully or not, to some talismanic *"res"*.

The inadequacy of dependence upon property concepts is demonstrated by the discussion in the opinion below of the decision in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (2nd Cir. 1953), *cert. denied* 346 U.S. 835 (1953), which, as Judge Kaufman observed, announced the demise of the *Clarke* rule (96a). In *Prudence-Bonds* it was contended that the indenture trustee had negligently failed to enforce a promise by a third party to pay the mortgages which secured the debt if the mortgagors defaulted. Judge Learned Hand, speaking for himself and Judges Swan and Frank, found that the broad authority of the reorganization court to implement a reorganization plan furnished ample basis for permitting suit against the indenture trustee. The majority below did not concede, however, that *Prudence-*

Bonds was inconsistent with *Clarke*, and gave this reason (91a):

> "The difference between failure to enforce a third party's guaranty of a mortgage assigned to an indenture trustee or other property held by it as security and failure to enforce a promise by the debtor is the highly significant one that the former has diminished the debtor's estate and the latter has not."

That analysis, however, is a *non sequitur*. The third party's guarantee in *Prudence-Bonds* may have been part of the trust *res*, but only by an agonizing stretch of imagination could it be deemed property of the debtor. The failure of the indenture trustee to enforce that guarantee had a drastic effect on the value of the bondholder's security, but made not the slightest dent in the debtor's estate.

If the question involved determining what constitutes the "property" of the debtor, it may be sound, as the Court below suggests, to view the promise to the bondholders by a third-party guarantor as "property" of the Debtor, whereas it would make little sense so to denominate a promise by the Debtor itself. But such sleight-of-hand only puts emphasis on creating (or demolishing) novel concepts of property, and has no reasonable relationship to the role of reorganization under Chapter X. The question at hand is not how elastic we should make our notion of a debtor's "property," but whether the reorganization trustee should be allowed to sue the indenture trustee. If he may sue the indenture trustee for negligently failing to enforce the promise of a third-party guarantor, may he not also sue for negligently failing to enforce the promise of the Debtor?[10] In either case there is a promise rather than "property" in any strict sense, and the cause of the loss to the debt investors is the indenture trustee's negligent failure to enforce a promise.

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[10] Even the majority below recognized that the debtor's own wrongdoing does not work an estoppel in an action by a reorganization trustee (89a). *McCandless* v. *Furlaud*, 296 U.S. 140 (1935).

Similarly subject to criticism is the summary rejection by the Court below of the decision in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3rd Cir. 1952), *cert. denied sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U.S. 940 (1953) (89a, n. 4). The Third Circuit in *Solar* permitted a reorganization trustee to counterclaim against an indenture trustee's account because the latter had failed to observe a covenant requiring it to earmark proceeds for the benefit of debenture holders should any of the debtor's major assets be sold. Again, as here, the ground for permitting the reorganization trustee to sue lay in wrongful breach of promise by the indenture trustee rather than in any mishandling of "property" pledged to secure the debt. *Solar*, in fact, is flatly inconsistent with the decision below, and really cannot be harmonized with *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943). Clearly *Solar*, and not *Clarke*, states the preferable rule.

Standing may inevitably be one of those legal issues which cannot be wholly freed from technicalities, but there is no need to plunge purposely into subleties which would elude a scholastic metaphysician. As Judge Kaufman pointed out, when a line of analysis "is seen to yield such awkward conclusions, it is perhaps better to re-examine the hypothesis than to ascribe to Congress an intent to fashion so irrational a design." (98a). The hypothesis which needs re-examination here is the notion that the propriety of permitting a reorganization trustee to sue an indenture trustee on behalf of debt investors should depend upon the whereabouts of the debtor's "property."

Turning to the question of whether the Trustee's suit against Marine would affect the plan of reorganization, the Court below was simply wrong to conclude that it would not. If the Trustee recovered the full face value of the debentures for the debenture holders, they would be paid off dollar for dollar, whereas from the estate itself they would get far less. Even if, as the majority below contended,

other general creditors would not be benefited because Marine would be subrogated to the rights of the debenture holders (92a), the Trustee's action would still be authorized. Since the debenture holders here are unsecured, they stand as mere general creditors and if someone else is subrogated to their rights it deprives other general creditors of nothing. On the other hand, the debenture holders would receive full value, and any action by a reorganization trustee which benefits the creditors in aggregate is clearly within his powers and duties. In fact, most actions prosecuted by a reorganization trustee benefit only a limited group, so it can be no criticism of the Trustee's suit that it would benefit debenture holders without harming other creditors. *Cf. In re Central States Electric Corp.*, 143 F.2d 684 (4th Cir. 1944).

Here, however, all general creditors would benefit if the Trustee prevailed in full against Marine, for Marine would not be permitted to subrogate. The majority below contended that if the Trustee prevailed, "Marine would simply be substituted for the debenture holders as the claimant" (92a), citing as the sole authority section 141 of the Restatement of Security (1941). That section, however, governs only the right of a *surety* to be subrogated to the rights of a debtor if he pays the debt. Unlike a surety or guarantor, an indenture trustee is not obligated in the first instance to make good on debentures if the debtor defaults. It will become liable to do so only by reason of its own wrongful breach of fiduciary duty. Rather than being entitled to subrogation under the principles of surety law, Marine would have to seek subrogation under the general equitable doctrine enunciated in section 162 of the Restatement of Restitution (1937):

> "Where property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the for-

> mer is entitled to be subrogated to the position of the obligee or lien-holder."

The question, in short, would be whether an indenture trustee found culpably responsible for the default on debentures is entitled to subrogation with respect to money which would otherwise go to innocent general creditors, on the ground that paying the money to them rather than him would constitute unjust enrichment. The statement of the proposition is its own refutation. It is settled law that negligent conduct will bar a party from subrogation. *A. Gusmer, Inc.* v. *McGrath*, 196 F.2d 860 (D.C. Cir. 1952); *see German Bank* v. *United States*, 148 U.S. 573 (1893). Further, subrogation will be allowed only where the equities of the party seeking subrogation are superior to those of the party against whom the right is asserted. *Bank of Fort Mill* v. *Lawyers Title Ins. Corp.*, 268 F.2d 313, 315 (4th Cir. 1959); *United States Fidelity & Guaranty Co.* v. *First National Bank in Dallas*, 172 F. 2d 258, 263 (5th Cir. 1949). Subrogation will not be allowed where the liability of the party claiming subrogation arises from a wholly different source than that of the primary obligor, *Meyers* v. *Bank of America*, 11 Col. 2d 92, 77 P.2d 1084, 1089 (1938), and subrogation will be denied when the claiming party is guilty of wrongful or unconscionable conduct. *American Surety Company* v. *Bethlehem National Bank*, 314 U.S. 314 (1941); *Lawrence Warehouse Co.* v. *Menary*, 143 F. Supp. 883 (S.D. Iowa 1956); *Standard Accidental Ins. Co.* v. *Pellecchia*, 15 N.J. 162, 104 A.2d 288, 302 (1954). Nor, finally, would Marine be entitled to reimbursement from the debtor under any theory of indemnification. *Ingham* v. *Eastern Airlines, Inc.*, 373 F.2d 227 (2d Cir. 1966), *cert. denied, sub. nom. United States* v. *Ingham*, 389 U.S. 931 (1967); *Globus* v. *Law Research Services, Inc.*, 418 F.2d 1276 (2d Cir. 1969) *cert. denied*, — U.S. — (1970); *State Mutual Life Assurance Co.* v. *Peat, Marwick, Mitchell & Co.*, 49 F.R.D. 202 (S.D.N.Y. 1969).

The last reason advanced by the Court of Appeals majority for concluding that it would not affect the plan

of reorganization to permit the Trustee to sue Marine was that the claim against Marine could not be prosecuted to judgment until the results of the reorganization were known, for otherwise the actual loss suffered by debenture holders could not be ascertained.

It is unreasonable to assume that whatever indeterminateness may be involved in a reorganization ought to be borne by innocent debt investors rather than by the indenture trustee who has been guilty of misfeasance. Such an approach would delay for many years the prosecution of claims against the indenture trustee. The problems of uncertainty of damages should not be borne by the innocent debenture holders, but should be resolved in the manner suggested by Judge Frank in *President and Directors of Manhattan Co.* v. *Kelby*, 147 F.2d 465, 476 (2d Cir. 1944), *cert. denied* 324 U.S. 866 (1945):

> "This case is governed by the rule that, where one has committed a wrong which renders impossible the exact ascertainment of damages, 'the risk of the uncertainty should be thrown upon the wrongdoer instead of upon the injured party. * * *' Story Parchment Co. v. Paterson Parchment Co., 282 U.S. 555, 563, 51 S. Ct. 248, 251, 75 L. Ed. 544. We recently held that rule applicable to a wrongdoing trustee. York v. Guaranty Trust Company, 143 F.2d 503, 517. We should not indulge in conjectures to lighten the burdens of such a trustee at the expense of its beneficiaries."

Finally, the question whether it will substantially affect plans of reorganization to permit reorganization trustees to sue on behalf of debt investors is an intensely practical question to which a pragmatic, rather than a theoretical, answer must be provided. Judge Kaufman, dissenting below, put the point forcefully (99a-100a):

> "Although the bondholders' recovery [may] swell directly only the purses of the bondholders, the

majority ignores the central consideration that certainty as to the bondholders' rights against the indenture trustee cannot fail to affect the views of the interested parties and the court in passing on the fairness of the reorganization plan. 11 U.S.C. § 621(2). The majority thus seems to misconstrue the true scope and nature of a reorganization proceeding. The process of reorganizing is not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed formulas.

Rather, the objective is carried out through a process of negotiation, and some give-and-take, in an attempt to adjust equitably and with sensitivity to the nuances of the individual case the rights of competing interested parties. As Judge L. Hand argued persuasively in dissenting from the decision in *Clarke*, the reorganization court has jurisdiction over a case such as this as part of its obligation to 'adjust the mutual rights of the debtor's creditors as between themselves.' 137 F.2d at 802. I see no reason for denying to the reorganization court, as the majority does, the power to discharge this obligation here or properly to perform its duty to adjudge the equitableness of a proposed reorganization plan."

In short, a plan of reorganization can be affected in many ways, some of which are susceptible to fine, theoretical analysis but many of which are not. For instance, an indenture trustee might well waive its asserted right to subrogation and the debenture holders, in consideration of a substantial payment from the indenture trustee, might well withdraw their claims, making possible a larger distribution to the other unsecured creditors. Such adjustment of rights is the essence of reorganization under Chapter X, as is evidenced by two recent proceedings. In *In re Continental Vending Machine Corp.*, E.D.N.Y. 63-B-663, the reorganization trustee negotiated a settlement under which the indenture trustee waived its priority over debenture holders who otherwise would have received

nothing from the estate, but who had a colorable cause of action against the indenture trustee. See SEC, 36th Annual Report 187 (1970). Without this settlement the debenture holders might have successfully opposed any plan and forced the debtor into straight bankruptcy.

A somewhat similar result was reached in *In re Dilbert's Leasing & Development Corp.*, E.D.N.Y. 63-B-148, where the reorganization trustee settled litigation commenced on behalf of debenture holders against the indenture trustee. The result was the creation of a fund for the benefit of the debenture holders which reduced their claims against the estate.

The Court of Appeals erroneously concluded that the question of the standing of a reorganization trustee to represent a debt investor depends upon the technicalities governing whether particular interests of the debtor constitute "property" or not. Further, the Court wrongly decided that it would not affect the plan of reorganization if the Trustee were successful in his litigation against Marine. Finally, the Court failed to appreciate the practical dynamics of bankruptcy reorganization, for it is indubitable that permitting the reorganization trustee to pursue all claims arising out of the bankruptcy will significantly enhance his ability to negotiate or compel the fairest and most equitable arrangement for all parties.[11]

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[11] *Continental Vending* and *Dilbert's, supra*, also exemplify the appropriateness of including recoveries on behalf of bondholders in a plan of reorganization. Although the Court below was of the view that Section 216 of the Bankruptcy Act, 11 U.S.C. § 616, contained no "rubrics" under which such matters could be included in a plan of reorganization, it overlooked Section 216(14) of the Act, 11 U.S.C. § 616(14) which indicates that a plan of reorganization

> ". . . may include any other appropriate provisions not inconsistent with the provisions of this chapter."

POINT II

The Trustee in reorganization is a real party in interest with respect to claims against an Indenture Trustee brought on behalf of debenture holders.

Rule 17(a) of the Federal Rules of Civil Procedure states that "every action shall be prosecuted in the name of the real party in interest," and that provision is made applicable in reorganization proceedings by General Order in Bankruptcy 37. In *Clarke* v. *Chase National Bank*, 137 F.2d 797, 801 (2d Cir. 1943), the Second Circuit cited this rule as an additional reason for not permitting a reorganization trustee to sue on behalf of debenture holders, and the majority below reiterated that view in this case (93a). This interpretation of the real-party-in-interest requirement is without support in reason, history, or precedent.

First, the Trustee is a real party in interest because it is part of his statutory duty to bring suits such as this one. It is, of course, the statutory duty of a reorganization trustee to represent all creditors, and if the Trustee is successful in his claim against Marine, the debenture holders will benefit. Moreover, if subrogation were denied to Marine, as in equity it ought to be, the other general creditors would directly benefit as well. Thus, success by the Trustee against Marine would benefit the general creditors in aggregate. Since an act performed by the Trustee which would, if successful, benefit creditors is one performed in the discharge of his statutory duty, it seems beyond question that he is acting as a real party in interest. There simply is no requirement that all acts of a reorganization trustee benefit creditors equally, nor can it conceivably be argued that a party discharging a statutory duty is not a real party in interest.

Not only is it demonstrable that the Trustee's action against Marine is one taken by the real party in interest because it is done in discharge of the Trustee's statutory

duty, but it is further clear that the same factors which determine whether the Trustee has standing to sue Marine are dispositive of the question under Rule 17(a). *United Federation of Postal Clerks AFL-CIO* v. *Watson*, 409 F. 2d 462, 470 (D.C. Cir. 1969). See also *Smith* v. *Board of Education*, 365 F. 2d 770, 777 (8th Cir. 1966) (Blackmun J.). Since, as the prior portion of this brief has shown, the Trustee unquestionably has standing to sue Marine, it follows that he meets the requirements of Rule 17(a).

Any contrary conclusion defies the history and purpose of Rule 17(a). The real party in interest requirement first appeared in New York in David Dudley Field's Civil Code of 1848. According to Professor Atkinson, "The Real Party in Interest Rule: A Plea for its Abolition," 32 N.Y.U.L. Rev. 926, 934-935 (1957), its original purpose was to permit suits at law by assignees of choses in action. As stated in the notes of the Advisory Committee on Rules for Civil Procedure:[12]

> "In its origin the rule concerning the real party-in-interest was permissive in purpose: it is designed to *allow* an assignee to sue in his own name. That having been accomplished, the modern function of the rule in its negative aspect is simply to protect the defendant against a subsequent action by the party actually entitled to recover, and to insure generally that the judgment will have its proper effect as res judicata."

In short, the real party in interest rule was adopted to liberalize practice not restrict it. *See Kilbourn* v. *Western Surety Co.*, 187 F. 2d 567, 571 (10th Cir. 1951). It never was intended to be used to bar suits brought to effectuate Congressional statutory policy or for the benefit of a large number of widely scattered investors. In fact, the rule has been abolished in New York, the state of its origin, in part because "it misleadingly seemed to say that the action must be brought by the party to be benefited." 2 Weinstein, Korn & Miller, New York Civil Practice ¶ 1004.01.

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[12] 3A Moore's Federal Practice, ¶17.01 [8] (2d ed. 1970).

In sum, the Trustee is a real party in interest because suit against Marine is brought pursuant to his statutory obligation. Further, the fact that he is a real party in interest flows necessarily from the conclusion that he has standing to sue on behalf of debt investors. Finally, the affirmative purpose behind the real party in interest requirement was solved long ago by other procedural innovations, and the negative purpose of guarding against improper *res judicata* effect has nothing to do with the present action. The Second Circuit, in short, has simply misunderstood and misused Rule 17(a).

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be reversed and the cause remanded to the District Court.

Respectfully submitted,

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APPENDIX A

Statutes Involved

Chapter X of The Bankruptcy Act, 11 U.S.C. § 501 *et seq.*, provides in pertinent part:

§ 167, 11 U.S.C. § 567. *Powers and duties; trustee*

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

* * *

§ 187, 11 U.S.C. § 587. *Same; rights, powers and duties*

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 72 of this title, and, if authorized by the judge, shall have and may exercise such additional rights and powers

as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

§ 212, 11 U.S.C. § 612. *Same; regulation by court*

"The judge may examine and disregard any provision of a * * * trust indenture * * * or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder * * *."

§ 216, 11 U.S.C. § 616. *Provisions of plan*

A plan of reorganization under this chapter—

* * *

(14) may include any other appropriate provisions not inconsistent with the provisions of this chapter.

The Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa *et seq.*, provides in pertinent part:

§ 77bbb. Necessity for regulation

(a) Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress pursuant to section 78jj of this title and otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected—

(1) when the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors, notwithstanding the fact that (A) individual action by

such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;

(2) when the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures (A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and (B) generally relieve the trustee from liability even for its own negligent action or failure to act;

(b) Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in

interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public; and it is declared to be the policy of this subchapter, in accordance with which policy all the provisions of this subchapter shall be interpreted, to meet the problems and eliminate the practices, enumerated in this section, connected with such public offerings.

* * *

§ 77ooo. Duties and responsibility of the trustee—

Duties prior to default

(a) The indenture to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 77nnn of this title to determine whether or not such evidence conforms to the requirements of the indenture.

* * *

Responsibility of the Trustee

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee

from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts; and

* * *

§ 77vvv. Court review of orders; jurisdiction of offenses and suits

* * *

(b) Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 77v(a) of this title.

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In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION[1]

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[1] The Securities and Exchange Commission is participating in the reorganization proceeding in the district court as a party pursuant to Section 208 of Chapter X of the Bankruptcy Act, 11 U.S.C. 608, and has taken positions in that court and in the court of appeals similar to the positions urged herein. As in *Protective Committee* v. *Anderson*, 390 U.S. 414, 420 n. 3, the Commission is "an unnamed respondent before this Court." See Rule 21(4) of the Rules of this Court.

OPINIONS BELOW

The opinion of the court of appeals (App. 84a-96a) is reported at 439 F. 2d 118. The opinions of the district court (App. 58a-61a, 62a-66a, 67a-70a) are not reported.

JURISDICTION

The judgment of the court of appeals was entered on March 3, 1971 (App. 82a). The petition for a writ of certiorari was filed on May 29, 1971, and granted on December 7, 1971. The jurisdiction of the Court rests on 28 U.S.C. 1254(1) and 11 U.S.C. 47c and 521.

QUESTION PRESENTED

Whether the reorganization trustee of a debtor in a proceeding under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, has standing, on behalf of a class of public investors holding debentures of the debtor, to prosecute their claims against their indenture trustee for willful misconduct or gross negligence in failing to enforce certain covenants of the debtor in the trust indenture, irrespective of whether such covenants related to specific property of the debtor.

STATUTES INVOLVED

The pertinent provisions of Sections 115, 167 and 187 of Chapter X of the Bankruptcy Act (11 U.S.C. 515, 567 and 587) and Section 315 of the Trust Indenture Act of 1939 (15 U.S.C. 77*ooo*), are set forth in an appendix to this brief, pp. 31-34, *infra*.

STATEMENT

This case involves the efforts of petitioner, appointed under Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, as trustee in reorganization of Webb & Knapp, Inc., to assert claims on behalf of holders of debentures issued to the public by Webb & Knapp against Marine Midland Grace Trust Company of New York ("Marine"), as trustee under an indenture pursuant to which the debentures were issued. The court of appeals held that petitioner lacked standing to pursue these claims since, in the court's view, no property of Webb & Knapp or other "res" was involved and any successful prosecution of the suit would not affect the reorganization of Webb & Knapp.

A. Backround

The Chapter X proceeding was initiated in May 1965, when Marine filed a petition in the district court seeking the involuntary reorganization of Webb & Knapp. The petition was approved and petitioner was appointed trustee (Rep. 2).[2] The Securities and Exchange Commission entered an appearance pursuant to Section 208 of Chapter X, 11 U.S.C. 608, and has actively participated in the proceeding.

Webb & Knapp and its numerous subsidiaries had been engaged in widely diversified real estate activities in the United States—principally New York

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[2] "Rep." refers to the report of the Chapter X trustee, prepared pursuant to Section 167 of Chapter X, 11 U.S.C. 567, and dated January 30, 1970.

City—and Canada (Rep. 15; App. 44a). Petitioner's accountants completed an audit of Webb & Knapp's books which showed that shortly after the Chapter X proceeding was begun, the company had total assets of $21,558,621 and total liabilities of $60,036,164, plus contingent tax liabilities of $29,400,000 (Rep. 98). Included in its liabilities were 5% Sinking Fund Debentures in the principal amount of $4,298,200 plus interest subsequent to the inception of the proceeding *(ibid.)*.

In June 1966, Marine, acting pursuant to Section 198 of Chapter X, 11 U.S.C. 598, filed a proof of claim in the district court on behalf of the debenture holders of $4,298,200 (App. 30a). In addition, Marine filed a proof of claim on its own behalf of $51,447.55, which it asserted was due it for services rendered and for disbursements and expenses incurred as indenture trustee (App. 30a-31a).

B. The Trust Indenture

In June 1954, Webb & Knapp and Marine executed a Trust Indenture providing for the issuance by Webb & Knapp of the 5% Sinking Fund Debentures, due June 1974, in the aggregate principal amount of $8,607,600 (App. 30a). In the indenture, which was qualified under the Trust Indenture Act of 1939 (15 U.S.C. 77aaa, *et seq.*) *(ibid.)*, Webb & Knapp made certain covenants and agreements to and with Marine for the benefit of the holders of the debentures to be issued under the indenture; Marine, on its part, undertook to perform certain duties and to use due

care in the exercise of its rights and powers under the indenture (App. 45a).

Specifically, Webb & Knapp covenanted in Section 3.6 of the indenture that neither it nor its consolidated subsidiaries would incur or assume certain indebtedness or purchase any real property or interests in real property, unless prior to such transaction the company's consolidated tangible assets, as defined in the indenture, equaled 200 percent of certain liabilities, after giving effect to the contemplated indebtedness or purchase (the "2 to 1 ratio") *(ibid.)*. Under Section 3.11, Webb & Knapp covenanted to file with Marine annually a certificate signed by responsible officers stating whether the company had defaulted on any of its covenants or agreements under the indenture during the preceding year (App. 45a-46a). Under Section 10.1(b) of the indenture, Marine was to be liable for its negligence or willful misconduct, except that it was entitled, in the absence of bad faith, to rely on certificates submitted to it which conformed to the requirements of the indenture.

C. Petitioner's Investigation and Claims Against Marine

Pursuant to Section 167 of Chapter X, 11 U.S.C. 567, petitioner, upon appointment as the Chapter X trustee, undertook an extensive investigation of the affairs of Webb & Knapp (Rep. 62, 65). As a result of that investigation, several suits were instituted, including a suit by petitioner against William Zeckendorf—Webb & Knapp's chief executive officer since 1942—and others, charging waste and mismanage-

ment of corporate assets and seeking substantial damages (Rep. 3, 63). In addition, petitioner reported that it was his opinion that Marine had either willfully or negligently failed to fulfill its obligations under the indenture (Rep. 65).

Petitioner requested and obtained an order from the reorganization judge authorizing him to commence an action against Marine "for the recovery of the damages sustained by virtue of the grossly negligent performance of its fiduciary obligations" (App. 41a). Petitioner asserted this claim both in an independent plenary action filed in the district court (App. 43a-48a) and in a counterclaim to Marine's claim for certain services (App. 49a-53a). In addition, petitioner moved in the reorganization proceeding that Marine be required to file an accounting (App. 42a).

In particular, petitioner alleged that from 1954 to 1964, Webb & Knapp's officers had prepared and submitted to Marine at Marine's request appraisals of Webb & Knapp's assets for the purpose of satisfying Marine that the 2 to 1 ratio of assets to liabilities required by Section 3.6 of the indenture was being maintained (App. 46a). Petitioner further alleged that these appraisals were fraudulent, in that they contained grossly overstated valuations of certain real estate properties owned by Webb & Knapp, and that at no time from 1958 through 1964 did Webb & Knapp comply with its covenant to maintain the 2 to 1 ratio (App. 46a-47a). Petitioner alleged that Marine knew or should have known that the appraisals were inflated, that Webb & Knapp was suf-

fering serious financial losses during the period, and that as a result the 2 to 1 ratio was not being maintained (App. 47a).[3] Webb & Knapp allegedly entered into countless transactions prohibited by Section 3.6 of the indenture because of the impaired assets-to-liabilities ratio, with the result that its net worth declined from $25,066,657 as of December 31, 1958, to a deficit of $38,500,000 when the Chapter X petition was filed in May 1965 (App. 47a-48a).

Finally, petitioner alleged that the failure of Marine to enforce the 2 to 1 ratio covenant "either constituted willful misconduct or gross negligence in violation of its [own] obligations as Indenture Trustee" (App. 48a). Damages were sought on behalf of the debenture holders of $4,298,200, the aggregate principal amount of the debentures at the time the reorganization proceeding was instituted, together with interest (App. 48a).

D. The Decisions of the Courts Below

The district court dismissed the complaint filed in the plenary action on the ground that petitioner lacked standing to assert the claim against Marine under the Second Circuit's decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, since no property of Webb & Knapp was involved (App. 58a-61a). A second order dismissed the trustee's counterclaim to Marine's $51,448 claim for services on the same

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[3] Beginning in 1958, Webb & Knapp sustained losses in every year but one, ranging from $1,026,484 in 1959 to $19,625,151 in 1962 and $32,320,953 in 1968, the year of Webb & Knapp's last audited report (App. 39a-40a).

ground (App. 64a). In the same order, Marine's motion to strike petitioner's objection to the claim for services was denied (App. 66a), thus allowing petitioner to assert his contention that Marine failed to carry out its obligations under the indenture, but only as an affirmative defense. Finally, in a third order, the district court denied petitioner's motion to compel Marine to file an accounting (App. 67a-70a).

On consolidated appeals, the court of appeals, in an *en banc* decision, followed its earlier decision in *Clarke* and affirmed the district court's orders (App. 85a-96a). The court denied petitioner standing on the ground that the asserted claim against Marine did not involve Webb & Knapp's property or a trust "res." Judges Kaufman and Hayes dissented in part, stating that they would overrule *Clarke* and permit petitioner to assert the counterclaim and maintain the plenary action (App. 96a-102a).

The court was unanimous in affirming the district court's denials of petitioner's motion for an accounting and Marine's motion to strike petitioner's objection to Marine's claim for services (App. 95a-96a).[4]

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[4] While Marine had cross-appealed to the court of appeals (App. 80a, 85a), it did not seek review in this Court of the court of appeals' affirmance of the denial of its motion. Accordingly, no issue is presented here with respect to the correctness of the ruling of the district court that petitioner may assert his contention that Marine failed to carry out its obligations under the indenture as a defense to Marine's claim for services.

SUMMARY OF ARGUMENT

The court below denied standing to petitioner, as trustee under Chapter X of the Bankruptcy Act, to sue Marine on behalf of the debtor's debenture holders on the ground the indenture trustee's activities had not adversely affected the debtor's "property" or a trust "res." In thus narrowly restricting the functions and powers of the Chapter X trustee, the court below failed to heed the mandate of this Court that legislation enacted for the protection of investors should be construed flexibly to effectuate its broad remedial purposes rather than technically or restrictively. Cf. *Securities and Exchange Commission* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195.

1. Both Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, and the Trust Indenture Act of 1939, 15 U.S.C. 77*aaa*, *et seq.*, were enacted following a comprehensive study by the Securities and Exchange Commission disclosing the lack of protection afforded public security holders either by the trustees under the indentures pursuant to which their securities were issued or in the reorganization proceedings which followed the insolvency of an issuer of such securities. A major concern of Congress in enacting the statutes was thus to protect public investors and provide them with a "focal point" for asserting their common interests in the reorganization process. The Trust Indenture Act provided bondholders with independent indenture trustees with powers and duties designed to enable and compel them vigorously to protect the bondholders' rights under indentures;

Chapter X provided for the appointment of a disinterested reorganization trustee with broad powers to investigate a debtor's affairs, formulate a plan of reorganization and generally to exercise the powers of a receiver in equity.

2. In keeping with the underlying purpose of Chapter X to protect public investors, the Chapter X trustee is the appropriate individual to investigate the performance of an indenture trustee's duties under an indenture pursuant to which a debtor's debentures were issued and to pursue on behalf of the debenture holders any causes of action disclosed by the investigation. The individual debenture holders may be ignorant of their rights and may not have the resources, either acting alone or in concert, successfully to prosecute an action against the indenture trustee. Moreover, since, as here, the Chapter X trustee may have to investigate and develop the facts surrounding alleged misconduct by an indenture trustee in response to claims asserted by the indenture trustee in the reorganization proceeding, the fostering of private suits based on the same conduct may result in an unnecessary duplication of fact-finding.

3. The court below, in following its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, unduly restricted the powers of the Chapter X trustee. By distinguishing later cases which had substantially limited the effect of the *Clarke* decision, the court imposed an artificial distinction, having no basis in logic or policy, between causes of action a reorganization trustee can maintain against an in-

denture trustee and those he cannot. The court also failed to appreciate the considerable effect that recovery by petitioner on behalf of the debenture holders would have on the reorganization process, whether or not Marine would be subrogated to the claims of the debenture holders against the estate of Webb & Knapp.

ARGUMENT

A CHAPTER X TRUSTEE HAS STANDING TO MAINTAIN AN ACTION ON BEHALF OF PUBLIC INVESTORS HOLDING DEBENTURES ISSUED BY THE DEBTOR AGAINST THEIR INDENTURE TRUSTEE FOR BREACH OF ANY FIDUCIARY DUTY OWED THEM UNDER THE INDENTURE

A. As the Legislative History and Provisions of Chapter X Make Clear, the Chapter X Trustee Is Invested with Broad Powers to Protect the Interests of Public Investors in a Debtor

This Court has noted that "in enacting Chapter X Congress had the protection of public investors * * * primarily in mind." *Securities and Exchange Commission* v. *American Trailer Rentals Co.*, 379 U.S. 594, 614. Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, enacted in 1938, stemmed from the same comprehensive study[5] conducted by the Securities and Exchange Commission, disclosing widespread abuses under the then existing reorganization procedures, that led the following year to the enactment of the Trust Indenture Act of 1939, 15

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[5] Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees* (hereinafter, "Study").

U.S.C. 77aaa, *et seq.* See II Loss, *Securities Regulation* 719 (2d ed., 1961). The two statutes together were intended to alleviate the unfortunate position that many public investors were in prior to 1938: the Trust Indenture Act by giving indenture trustees vastly increased powers and duties; Chapter X by empowering the disinterested Chapter X trustee to serve as a focal point for asserting the interests of the investors in the reorganization process.

The Commission's study focused in the main on the lack of investor protection in the reorganization process, and considered specifically the unsatisfactory performance of many indenture trustees. The study found that by and large the indenture trustee had been controlled by the management of the company issuing securities under the indenture and the bankers. Study, pt. I, at 329. This dominance resulted not only from direct control of indenture trustees through corporate affiliations such as interlocking directorates, but also from the fact that indenture trustees were under no meaningful contractual obligation to assume an active role—although they had the power to do so[6]—in the protection of investors

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[6] In Part VI of the study, the Commission noted (at p. 4):

> [T]ypically the [indenture] trustees do not exercise the elaborate powers which are the bondholders' only protection; * * * they have taken virtually all of the powers designed to protect the bondholders, but have rejected any duty to exercise them; and * * * they have shorn themselves of all responsibilities which normally trusteeship imports. The "so-called trustee" which is left is merely a clerical agency and a formal instrument which can be used by the bondholders when and if enough of them combine as specified in the indenture.

even after the issuing company defaulted on its obligations (*id.* at 333). The Commission recommended that indenture trustees "be transformed into active trustees with the obligation to exercise that degree of care and diligence which the law attaches to such high fiduciary position." Study, pt. VI, at 110.

The study also noted that the average security holder was in an almost helpless situation in reorganizations, both as a result of his probable inexperience in the complex aspects of corporate finance and law and as a result of the fact that the pursuit of his rights would involve expenditures greatly out of proportion to the amount of his investment. Study, pt. II, at 1. Because it found the existing reorganization procedures inadequate to relieve the individual investor from this unenviable position the Commission recommended that the whole reorganization process be refashioned so that "primary emphasis be given to the protection of the interests of investors." Study, pt. I, at 897.

Specifically, the Commission recommended that a qualified and disinterested reorganization trustee be appointed in virtually all corporate reorganizations to "supplant the system of leaving the debtor in possession or of appointing 'friendly' trustees" (*id.* at 899). In the Commission's view *(ibid.)*:

> Greater assurance would be provided that the public interest, no less than the immediate interests of creditors and stockholders, would be served by removing * * * [control of the reorganization process] from those whose interests are frequently incompatible with the interests of investors.

The plight of individual investors in reorganization proceedings was again a subject of concern at the Hearings before the House Judiciary Committee on the bill which eventually became the Chandler Act, revising the predecessor of Chapter X.[7] Then Commissioner, now Mr. Justice, Douglas testified on behalf of the Commission that (House Hearings, pp. 163, 164):

> There is, admittedly, a widespread and national investor interest in these reorganization proceedings. Certainly in the larger cases the securities are widely held. The holdings are small, and individual action by the security holders, to protect themselves, is, in many cases, out of the question. They either lack the funds, or the skill, the acumen or the initiative to take matters into their own hands. They are frequently without any adequate representation in the proceedings. Even should they desire to organize for mutual protection, they normally will find that the lists of their fellow security holders are not readily available. They are at the mercy of the inside groups—the management and the investment bankers. And the records show that these inside groups frequently have objectives which are incompatible with the objectives of investors. They are interested in concealing claims for fraud or mismanagement; investors are interested in collecting on those claims. * * *
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[7] Hearings on H.R. 6439 Before the House Committee on the Judiciary, 75th Cong., 1st Sess. (hereinafter, "House Hearings"). H.R. 6439 was later amended, reintroduced and reported as H.R. 8046.

> The new system which is needed must afford not only a shield but a sword for bona-fide investors and their representatives.

In the witness' view, the "keystone" to the new system was the creation of an independent reorganization trustee (*id.* at 165).

Finally, the critical role of the reorganization trustee with respect to the protection of public investors was emphasized in the House Report on what became the Chandler Act (H. Rep. No. 1409, 75th Cong., 1st Sess., pp. 43, 44):

> There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest. * * *.
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> This shift in power, inherent in the device of an independent trustee, is basic and fundamental if the reorganization system is to be reconstituted in the interest of investors.

2. In response to this demonstrated need to protect investors by assuring them of a vigorous and faithful trustee under the indenture pursuant to which their securities were issued and by providing them with an independent reorganization trustee who would jealously guard and pursue their rights in the reorganization process, Congress enacted Chapter X of the Bankruptcy Act, 11 U.S.C. 501, *et seq.*, and, one year later, the Trust Indenture Act of 1939, 15 U.S.C. 77aaa, *et seq.*

The Trust Indenture Act contains numerous provisions governing the content of trust indentures with respect to the qualifications, duties and powers of the indenture trustee.[8] With respect to the rights of the holders of securities issued under the indenture, the Act empowers the indenture trustee to sue and recover judgment from the issuer of the securities in the event of a default in the payment of principal or interest and to file claims in any judicial proceedings affecting the issuer or its property (Section 317(a); 15 U.S.C. 77qqq(a)). In addition to its powers under the Trust Indenture Act, the indenture trustee is authorized under Chapter X to institute an involuntary reorganization proceeding against an issuer (Section 126, 11 U.S.C. 526), to file claims on behalf of its security holders (Section 198, 11 U.S.C. 598) and "to be heard on all matters" in the reorganization proceeding (Section 206, 11 U.S.C. 606). See also Sections 171, 180 and 242(1), 11 U.S.C. 571, 580 and 642(1).[9]

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[8] The Act provides, for example, that the indenture must provide for the disqualification of the trustee if he acquires certain conflicting interests (Section 310(b), 15 U.S.C. 77 jjj (b)); must require the trustee to examine all evidence furnished to it to determine whether it conforms to the requirements of the indenture (Section 315(a), 15 U.S.C. 77ooo(a)); must require the trustee to use due care (Section 315(c), 15 U.S.C. 77ooo(c)); and cannot contain exculpatory provisions, save in limited situations (Section 315(d), 15 U.S.C. 77ooo(d)).

[9] While Congress gave indenture trustees a considerable role to play in Chapter X proceedings, it also gave the reorganization court strong measures of control over their activities. See Sections 211-213 of Chapter X, 11 U.S.C. 611-613.

The individual upon whom investors must rely primarily for the protection of their rights in reorganization proceedings, however, is not the indenture trustee, but the reorganization or Chapter X trustee. The Chapter X trustee, who must be disinterested (Sections 156, 158, 11 U.S.C. 556, 558), is given broad powers. He must, for example, at the direction of the reorganization court, conduct a thorough investigation into the affairs of the company undergoing reorganization and report to the court any facts pertaining to fraud or misconduct and any causes of action available to the estate (Section 167, 11 U.S.C. 567). The reorganization trustee is also charged with the responsibility of formulating a plan of reorganization (Section 169, 11 U.S.C. 569).

The importance of these powers has been stressed by the courts. See *e.g.*, *In Re South State Street Building Corporation*, 105 F. 2d 680, 682 (C.A. 7). Where, as here, there are allegations of gross dereliction of duty, the trustee is required to make an investigation "of the most complete and thorough-going character." *Committee* v. *Kent*, 143 F. 2d 684, 686 (C.A. 4). Opportunities for recoveries on causes of action may have been overlooked by the management of the corporation, either out of negligence or out of a desire to conceal its own wrongdoing. Indeed, breaches of trust by an indenture trustee may never come to light until the debtor is undergoing reorganization and a thorough independent investigation is made.

In addition to the powers and duties specifically enumerated in Chapter X, the Chapter X trustee is

also given the same rights and duties as a trustee appointed in ordinary bankruptcy proceedings (Sections 186, 187, 11 U.S.C. 586, 587). Thus he is vested with title to specified classes of the debtor's property, including various causes of action (Section 70a of the Bankruptcy Act, 11 U.S.C. 110(a)) and given rights to manage the property, reduce the property to money and close up the debtor's affairs (Section 47, 11 U.S.C. 75).

Finally, beyond the specifically enumerated rights and the rights incorporated by reference, it is standard procedure that the Chapter X trustee be given in his order of appointment[10] "such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor," to the extent not inconsistent with the other Chapter X provisions (Section 187 of Chapter X, 11 U.S.C. 587). Such additional rights and powers were given to petitioner in this case (App. 44a).

3. In assessing the scope of the Chapter X trustee's powers and duties, it is necessary to keep in mind that the essential purpose of a Chapter X reorganization is not, as in other bankruptcy proceedings, to afford a bankrupt an opportunity to be discharged from its debts, but is to provide investors and creditors with an effective method of protecting their

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[10] In a Chapter X proceeding, the district court is invested, in addition to numerous specific powers, with all the powers of a court presiding over a receivership in equity, to the extent such powers are not inconsistent with the other provisions of Chapter X (Section 115 of Chapter X, 11 U.S.C. 515).

interests. This concept was stressed in Commissioner Douglas' testimony before the House Judiciary Committee (House Hearings, p. 172):

> Under the new act the legal concept of the debtor is not carried completely into the statute. It is the investor concept all the way through. What does the debtor mean? The debtor, practically, as distinguished from legally, means nothing more nor less than the old management. * * * We are looking at it from the viewpoint of the investors' interest in these estates.

Thus, for example, there is no legal impediment to a reorganization under Chapter X on account of the misconduct of the debtor corporation,[11] since the statute seeks to protect the rights of the debtor's creditors and stockholders as against, *inter alia*, the wrongs of the debtor's former management. In this perspective, the entity undergoing reorganization is not merely the debtor corporation, but is essentially the collection of classes of creditors and stockholders who are arrayed, for purposes of participating in a plan of reorganization or for receiving a distribution of assets of the corporation, in a hierarchical order in accordance with their legal priorities. Accordingly, a Chapter X trustee's lawsuit "on behalf of the estate" becomes, in reality, on behalf of that class of creditors or stockholders who will happen to benefit from any recovery.

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[11] By way of contrast, a bankrupt in ordinary bankruptcy may not receive a discharge of all or some of his obligations if he has been guilty of certain acts (Sections 14(c) and 17(a), 11 U.S.C. 32(c) and 35(a)). See also Section 366(3), 11 U.S.C. 766(3).

B. The Chapter X Trustee Is the Appropriate Person to Enforce the Rights of Debenture Holders Against an Indenture Trustee

In view of the focus in Chapter X reorganization proceedings on the public investors rather than on the debtor itself and Congress' preoccupation with the protection of those investors, the Chapter X trustee is the appropriate person to bring an action on behalf of debenture holders against an indenture trustee for breach of its fiduciary obligations. The facts giving rise to such a cause of action will often be complex and difficult to uncover. The Chapter X trustee, with his powers of investigation under Section 167 of Chapter X, 11 U.S.C. 567, is in the best position to discover and assemble the relevant facts and present them in one suit on behalf of all members of a given class of investors.[12] Left to his own resources, the individual security holder may be wholly ignorant of his rights, or be unable to ascertain the relevant facts or enforce his rights.

The advantages of giving the reorganization trustee standing to pursue claims against an indenture trustee are well illustrated by this case. Apart from peti-

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[12] See *In the Matter of Manufacturers Credit Corporation v. Securities and Exchange Commission*, 395 F. 2d 833, 842 (C.A. 3), where the court, in comparing advantages to public investors to be found in Chapter X against their position in a proceeding under Chapter XI of the Bankruptcy Act, noted that actions for "potential remedies which the Securities Act of 1933 may afford innocent investors against those from whom they purchased the notes * * * and for others, which may be disclosed by his investigation, can be more effectively prosecuted by a Chapter X trustee than by the individuals concerned."

tioner's actions, three other suits have been filed against Marine on behalf of debenture holders—two state and one federal. These cases face uncertain futures.[13] Moreover, even if the private cases were successfully prosecuted to judgment, there could still be—in the words of Judge Kaufman, dissenting below (App. 101a)—"a massive redundancy of fact-finding."[14] For in this case, the reorganization court will have to consider fully petitioner's allegations against Marine even if the decision below is affirmed, since petitioner was permitted to interpose his claims as objections to Marine's claim for services (see p. 8, *supra*).

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[13] In one of these suits, *Lewis* v. *Marine Midland Grace Trust Co.*, New York Law Journal, June 28, 1968, p. 12, col. 2, the class action brought on behalf of Webb & Knapp debenture holders was dismissed on the ground that a class action in New York may not be prosecuted on such claims under the rule of *Elkind* v. *Chase National Bank*, 259 App. Div. 661, 20 N.Y.S. 2d 213 (1st Dept.), affirmed, 284 N.Y. 726, overruled in part by statute. Laws, 1950, ch. 812, N.Y. Personal Property Law 41.4. In a second state court action brought by a different debenture holder, the *Elkind* rule was rejected and the class action was allowed to be continued. *Ray* v. *Marine Midland Grace Trust Co.*, New York Supreme Court, New York County, Index No. 2159-1967, Jan. 8, 1971. Marine is appealing from that decision. A similar action, pending in the United States District Court since 1968, *Lewis* v. *Marine Midland Grace Trust Co. of New York*, 68 Civ. 1764 (S.D.N.Y.), has not moved forward. A motion to dismiss the complaint by Marine and other defendants is pending and discovery has not yet commenced.

[14] This redundancy could possibly be ameliorated through the application of the principles of collateral estoppel or *res judicata*. See *Blonder-Tongue Laboratories, Inc.* v. *University of Illinois Foundation*, 402 U.S. 313, 333. See also *Katchen* v. *Landy*, 382 U.S. 323, 334.

That the reorganization trustee could be a suitable representative of public investors in pursuing their claims against an indenture trustee, can hardly be doubted. As we have noted, his independence is guaranteed by statute (Sections 156, 158, 11 U.S.C. 556, 558) and his investigatory powers are broad (Section 167, 11 U.S.C. 567). The attorneys representing him must also be disinterested (Section 157, 11 U.S.C. 557). To deny that the trustee and his attorneys will vigorously and effectively represent public investors is to reject the whole concept of Chapter X reorganizations and their focus on the interests of investors.

C. In Denying Petitioner Standing, the Court of Appeals Construed the Powers of the Chapter X Trustee Unduly Narrowly and Failed Properly to Assess the Impact of Recovery Here on the Reorganization Process

1. In following its earlier decision in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, and holding that petitioner lacks standing to assert the claims of debenture holders against Marine, the court below stressed its view that the claims did not concern "property" of Webb & Knapp within the meaning of the Bankruptcy Act (App. 93a-94a). In our view, the court gave an unduly narrow construction to the relevant provisions of the Bankruptcy Act and drew artificial distinctions between claims which a Chapter X trustee could assert against indenture trustees and those he could not.

With respect to the Bankruptcy Act, the court stressed the provisions listing particular types of

debtor property to which the trustee acquired title (Section 70a, 11 U.S.C. 110(a)) and specifying the power of the trustee to collect and reduce to money such property (Section 47, 11 U.S.C. 75), and concluded that "nothing in the statute allows him to collect any moneys or other property not owed to or owned by the estate * * *" (App. 93a). Section 187 of Chapter X, 11 U.S.C. 587, however, expressly gives the trustee, when, as here, authorized by the reorganization court, the powers of a receiver in equity.

The broad scope of the powers of a receiver in equity have been recognized by this Court. In *McCandless* v. *Furlaud*, 296 U.S. 140, an equity receiver of an insolvent company was held to possess the requisite capacity to sue the promoters for defrauding *creditors* of the company. Mr. Justice Cardozo noted (296 U.S. at 160-161):

> A court of equity has taken hold of the assets of this company, intangible assets as well as tangible, for administration as a trust in accordance with equitable principles. * * * Included in those assets are monies fraudulently diverted to the prejudice of creditors. * * * There is power at the instance of the receiver to bring them back into the trust * * * [citations omitted].

Thus, as highlighted by the dissent in that case, the Court held in essence "that, if individual creditors have at the date of the receivership their own causes of action against third parties for fraud or misrepresentation, upon the appointment of a receiver these

causes of action are assigned in law to the receiver" (296 U.S. at 173-174).[15]

In concentrating on the various classifications of debtor property, the court of appeals gave insufficient attention to the essential purposes of Chapter X reorganizations—to provide investors and creditors with a tool for protecting their interests and to promote the development of a comprehensive reorganization plan. As we have noted (pp. 18-19, *supra*) Chapter X was designed throughout with "the investor concept" in mind (House Hearings, p. 172).

2. The decision below represents a step backward in the recognition of the Chapter X trustee's broad role in the reorganization process. The harsh rule announced in *Clarke* had in effect been limited, before being reaffirmed below, by a subsequent opinion of Judge Learned Hand (who vigorously dissented in *Clarke*) in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (C.A. 2), certiorari denied, 346 U.S. 835, holding that a Chapter X trustee had standing on behalf of certain bondholders to sue an indenture trustee for failure to pursue a guarantee of a defaulted mortgage pledged by a debtor as collateral for the bonds. In a similar decision, the Third Circuit held in *In re Solar Manufacturing Corp.*, 200 F. 2d 227, certiorari denied, 345 U.S. 940, that a

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[15] For a discussion of the powers of an equity receiver to sue on behalf of creditors, as disinguished from the corporation itself, see Note, *Power of Receiver for Corporation to Assert Causes of Action Vested Solely in Creditors*, 46 Yale L.J. 1229; and Note, *Corporations, Rights of Creditors of Insolvent Corporation—Greater than Rights of Corporation*, 34 Mich. L. Rev. 1196.

Chapter X trustee could assert the claims of debenture holders against the indenture trustee for failure to earmark certain funds of the debtor for the debenture holders as required by the indenture.

The court below sought to distinguish both *Prudence-Bonds* and *Solar* on the theory that the Chapter X trustee in each case was asserting a claim to a part of the trust "res."[16] The court recognized that, if Marine had held property of Webb & Knapp through a pledge or as the result of payments into a sinking fund, petitioner would have standing to sue (App. 91a). The above distinctions are unpersuasive and have no basis in logic or policy.

In each of the three cases—*Prudence-Bonds*, *Solar* and the instant case—the Chapter X trustee's primary concern in attempting to sue the indenture trustee was to protect the interests of the public investors; in each case, recovery was sought from the indenture trustee for the benefit of the bondholders and the issue was whether the indenture trustee had

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[16] In *Prudence-Bonds*, the indenture trustee had had possession of the mortgages pledged by the debtor, and the guaranty to pay defaulted principal and interest on the mortgages was considered as part of the "res." But, as noted in the dissent below (App. 99a), the action in *Prudence-Bonds*, as here, was one for an accounting for the loss to the bondholders that resulted from the indenture trustee's breach of duty and was not an action for restoration of the trust fund or the debtor's property. Similarly, although the court in *Solar* described the cause of action there as "quasi in rem for the benefit of the trust" and "for the restoration of trust funds," 200 F. 2d at 332, the suit was brought by the Chapter X trustee for the benefit of the debenture holders to whom the indenture trustee owed a fiduciary duty.

been "derelict in his duties" (see Judge Learned Hand's dissent in *Clarke*, 137 F. 2d at 802). To permit recovery only when the alleged breach of duty can be traced to property which at one time had been in possession of the indenture trustee is to draw an artificial line between groups of investors—protecting those on one side but not the other. The Bankruptcy Act, however, was intended to benefit all classes of creditors. See *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 114.

3. The court of appeals also relied on the ground that even a complete recovery by petitioner on behalf of the debenture holders would not materially affect the reorganization process (App. 91a-92a). In the court's view, other creditors and stockholders would not benefit from such recovery, since "[a]s a result of subrogation Marine would simply be substituted for the debenture holders as the claimant" against the estate of Webb & Knapp (App. 92a).[17] But it is by no means clear that Marine could benefit from subrogation, since, as this Court long ago pointed out in *Memphis and L.R.R.* v. *Dow*, 120 U.S. 287, 301-302:

> The right of subrogation is not founded on contract. It is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice; and is independent of any contractual relations between the parties.

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[17] The court failed to note that its conclusion would be equally applicable to an action which would be permitted under the rationale of the *Prudence-Bonds* decision.

The same view has been reiterated in subsequent cases. See, *e.g.*, *A. Gusmer, Inc.* v. *McGrath*, 196 F. 2d 860, 862 (C.A.D.C.). The reorganization court is a court of equity, see, *e.g.*, *Securities and Exchange Commission* v. *United States Realty & Improvement Co.*, 310 U.S. 434, 455, and thus would have to balance any claims asserted by Marine through subrogation against claims of other creditors who might have assumed, to their detriment, that Marine was diligently performing its duties under the indenture. Grossly negligent conduct comparable to the conduct with which Marine is charged here has been held sufficient to preclude a party from asserting the equitable doctrine of subrogation. See, *German Bank* v. *United States*, 148 U.S. 573; *A. Gusmer, Inc.* v. *McGrath*, *supra*.[18]

Even if Marine were entitled to full subrogation so that other creditors would not benefit as a result of recovery by the debenture holders, however, it does not follow that the reorganization process would not be materially affected by such recovery. In the first place, satisfaction of the debenture holders' claims is, we submit, an integral part of a Chapter X reorganization. As we have shown, the legislative history of Chapter X makes clear that Congress intended the reorganization trustee to vigorously assert the interests of the public investors. See *In re Solar Manufacturing Corp.*, *supra*, 200 F. 2d at 333.

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[18] Indeed, in *Clarke*, the court of appeals acknowledged that an indenture trustee's behavior "may be found to preclude * * * subrogation" to the claims of debenture holders in the course of reorganization. 137 F. 2d at 801.

There is no requirement that the trustee pursue only those actions which benefit all creditors, rather than a particular class of creditors such as debenture holders. Indeed, as a practical matter, any recovery by a Chapter X trustee on behalf of the estate will often benefit only a single class of the debtor's security holders.

In any event, the other creditors would be in no worse position if petitioner successfully prosecutes his claims against Marine[19] and the debenture holders would be in a better position, since they might receive as much as one hundred cents on the dollar instead of the fraction of that amount which they may receive in the reorganization.[20] Moreover, the fate of a substantial body of public creditors—the debenture holders—may be a critical factor in developing a successful reorganization plan, for, as Judge Kaufman pointed out in his dissent (App. 99a-

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[19] The burden on the estate of litigating the debenture claims would appear to be minimal, for petitioner would have to prove the same facts in his objection to Marine's claim for services (see p. 21, *supra*).

[20] A plan of reorganization has been submitted by petitioner to the reorganization court. At hearings on the plan, petitioner submitted evidence showing that the estimated value of Webb & Knapp's remaining assets was approximately $5,500,000, whereas its liabilities aggregated approximately $31,300,000, of which $27,700,000 represented unsecured claims. It would thus appear that, after deducting an estimated $900,000 for the expenses of administering the estate, the unsecured creditors, including the debenture holders, would receive approximately 4 cents on the dollar under the plan. See the Commission's Memorandum on the Trustee's Proposed Plan of Reorganization, pp. 3-4, 15-17 (filed in the reorganization court on January 27, 1972). We are lodging a copy of this memorandum with the Clerk of this Court.

100a), recovery by the debenture holders could have a substantial effect on the view of interested parties and the court in negotiating and considering an overall reorganization plan.

4. The majority below stated that petitioner, even if granted standing, could not ultimately prevail on its claims against Marine until the results of the reorganization became known, since only then could the damages of the debenture holders from Marine's alleged misconduct be ascertained (App. 92a). In our view, however, such a delay in recovery is not necessary and any resultant uncertainty as to the actual amount of damages suffered by the debenture holders should be resolved in their favor and against Marine. As Judge Frank noted in *President and Directors of Manhattan Co.* v. *Kelby*, 147 F. 2d 465, 476 (C.A. 2):[21]

> * * * [W]here one has committed a wrong which renders impossible the exact ascertainment of damages, "the risk of the uncertainty should be thrown upon the wrongdoer instead of upon the injured party. * * *" *Story Parchment Co.* v. *Patterson Parchment Co.*, 282 U.S. 555, 563 * * *. We should not indulge in conjectures to lighten the burdens of * * * [a wrongdoing trustee] at the expense of its beneficiaries.

[21] In that case, a bank had wrongfully permitted withdrawals from a fund maintained by it for the benefit of certain bondholders and the court required the bank, as trustee, to replenish the fund notwithstanding the fact that it could never be known with precision what the bondholders' positions would have been had the improper withdrawals not been made. 147 F. 2d at 476-477.

If there were subrogation, Marine might, upon ultimate distribution under a reorganization plan, recover part of any damages paid to the debenture holders. In this respect, Marine is undoubtedly in a better position than most debenture holders to await distribution under a plan.

CONCLUSION

For the foregoing reasons, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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APPENDIX

STATUTES INVOLVED

Chapter X of the Bankruptcy Act (11 U.S.C. 501, *et seq.*) provides in pertinent part:

Section 115 (11 U.S.C. 515):

> Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature.

Section 167 (11 U.S.C. 567):

> The trustee upon his appointment and qualification—
>
> (1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;
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> (2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;
>
> (3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;
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> * * * *

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

(6) shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named.

Section 187 (11 U.S.C. 587):

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

Section 315 of the Trust Indenture Act of 1939, 15 U.S.C. 77*ooo*, provides in pertinent part:

(a) The indenture to be qualified may provide that, prior to default (as such term is defined in such indenture)—

(1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and

(2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but such indenture shall contain provisions requiring the indenture trustee to examine the evidence furnished to it pursuant to section 314 to determine whether or not such evidence conforms to the requirements of the indenture.

* * * * *

(c) The indenture to be qualified shall contain provisions requiring the indenture trustee to exercise in case of default (as such term is defined in such indenture) such of the rights and powers vested in it by such indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

(d) The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that—

(1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;

(2) such indenture may contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved

that such trustee was negligent in ascertaining the pertinent facts; and

(3) such indenture may contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding (determined as provided in subsection (a) of section 316) relating to the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture.

* * * *

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IN THE

Supreme Court of the United States

October Term, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of WEBB & KNAPP, INC., on behalf of debentureholders under a trust indenture of Webb & Knapp, Inc. to The Marine Midland Trust Company of New York, trustee, dated as of June 1, 1954,

Petitioner,

—against—

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT

Opinions Below

The *en banc* opinion of the Court of Appeals (App. 84a-96a) is reported at 439 F. 2d 118. The opinions of the District Court (App. 58a-61a, 62a-66a, 67a-70a) are not reported.

Jurisdiction

The judgment of the Court of Appeals was entered on March 3, 1971 (App. 82a). The petition for a writ of certiorari was filed on May 29, 1971, and granted on December 7, 1971. The jurisdiction of the Court rests on 28 U.S.C. § 1254(1) and 11 U.S.C. §§ 47c and 521.

Question Presented

Does a trustee in reorganization under Chapter X of the Bankruptcy Act have standing to prosecute a private negligence cause of action in which the debtor has no interest, on behalf of an alleged class of debentureholders of which he is not a member, where any recovery admittedly would be paid to the debentureholders and not to the debtor and would not affect any plan of reorganization, and where the same claims are being prosecuted simultaneously in both federal and state courts of New York by debentureholders and a debentureholders' protective committee suing on their own behalf and representatively on behalf of all purchasers and all present and former holders of the debentures?

Statutes Involved

The pertinent provisions of Sections 47a and 70a of the Bankruptcy Act, 11 U.S.C. §§75a and 110a, and of Sections 167, 186, and 187 of Chapter X of that Act, 11 U.S.C. §§ 567, 586, and 587, as well as Section 312 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*lll*, are set forth in an appendix to this brief, pp. A-1–A-5, *infra*.

Statement of the Case

By this appeal the trustee in reorganization of Webb & Knapp, Inc. seeks a judicial extension of the statutory powers granted him by the Bankruptcy Act in order to enable him to prosecute a private claim for damages on behalf of holders of unsecured debentures issued by Webb & Knapp. The claim in question is based on an alleged failure of Marine Midland Grace Trust Company of New York, as indenture trustee, to prevent Webb & Knapp from violating a particular negative covenant it undertook for the benefit of the debentureholders.

The petitioner attempts by this appeal to supersede as representative of the debentureholders the members of that group who have already asserted the same cause of action in a representative capacity in both federal and state courts in New York, and thus to preempt the class action field which heretofore has been carefully developed and regulated within the framework of Rule 23 of the Federal Rules of Civil Procedure and similar state remedies.

A. The Trust Indenture

On or about June 1, 1954 Webb & Knapp and Marine Midland, as indenture trustee, executed an indenture providing for the issuance by Webb & Knapp of 5% Sinking Fund Debentures due June 1, 1974 in the aggregate principal amount of $8,607,000, of which the principal amount of $4,298,200 remains outstanding (App. 44a-45a). The indenture was entered into and qualified in accordance with the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa, *et seq.* (App. 30a), and there is no claim that any provision required by the Act to be included in the indenture was not

included or that the indenture contains any provision prohibited by the Act.

The alleged breach of covenant by Webb & Knapp and the supposed failure of enforcement by Marine Midland concern Section 3.6 of the Indenture. Webb & Knapp there covenanted that so long as any of the debentures remained outstanding, it would not incur or assume indebtedness resulting from borrowings or from the purchase of real property or interests in real property on which it would be personally liable or to purchase any real estate, or interest in real estate, unless on the basis of computations (made as of the last day of the fourth month prior to such transaction) its "consolidated tangible assets" would equal 200% of certain liabilities. In determining "consolidated tangible assets" the Company was authorized, *inter alia*, to rely on and use appraisals made by its officers and approved by the Board of Directors "of real property, of interests in real property . . . or of the controlling stock interest in any corporation the principal assets of which consist of real property or interests in real property" (App. 45a; Indenture pp. 11-13).

The Company was required to file an officers' certificate of compliance annually with Marine Midland and did so (App. 45a-46a). In addition to such certificates, pursuant to the indenture Marine Midland requested and received separate officers' certificates stating specifically that Webb & Knapp was not in violation of Section 3.6 (App. 46a).

In accordance with Section 315 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*ooo*, Section 10.1 of the indenture required Marine Midland to examine all certificates and reports furnished to it but authorized it, in the absence of bad

faith, to "conclusively rely as to the truth of the statements and the correctness of the opinions expressed therein, upon certificates or opinions conforming to the requirements of this indenture" and to "rely" and "be protected in acting or refraining from acting upon any resolution, certificate, opinion, notice, consent, request, order, appraisal, report, bond or other paper or document believed by it to be genuine and to have been signed and presented by the proper party or parties."

B. The Chapter X Trustee's Action

The pleadings do not put in issue the genuineness of the officers' certificates or appraisals furnished by Webb & Knapp or challenge their conformity to the requirements of the indenture. Nor is bad faith on the part of Marine Midland alleged.

The Chapter X trustee alleges, rather, that appraisals delivered to Marine Midland with the Section 3.6 certificates of compliance were "false and fraudulent and in fact at no time during the period 1958 through 1964 were the debtor's consolidated tangible assets equal to 200% of its liabilities as required by Section 3.6 of the indenture" (App. 46a-47a). He further contends that "Marine at all times knew, or in the exercise of reasonable diligence, should have known" that the officers' appraisals were "falsely and fraudulently inflated" and that "the ratio of the debtor's consolidated tangible assets to its liabilities was such that any borrowings or purchases by the debtor would and did constitute violations of the debtor's covenants as set forth in Section 3.6 of the indenture" (App. 47a).

The conclusory allegation is that Marine Midland's "failure to ascertain that the debtor was in violation of its obligations pursuant to the provisions of Section 3.6 of the in-

denture and its failure to take appropriate steps to protect the debentureholders [by preventing the debtor from borrowing any money or purchasing any property while the debentures were outstanding] either constituted wilful misconduct or gross negligence in violation of its obligations as Indenture Trustee" (App. 48a).

The reorganization trustee concludes that "by reason of the foregoing, the holders of the debtor's debentures under the indenture have suffered damages in the amount of $4,298,200" and demands judgment on their behalf (App. 48a).

There is no allegation in the trustee's complaint that Marine Midland at any time mishandled or even held any property belonging to Webb & Knapp or any property in which it had an interest, or received any money or other property in preference of its own interests over those of Webb & Knapp or its creditors or debentureholders, or otherwise engaged in any self-dealing. Nor is it alleged that Marine Midland released or surrendered or otherwise acted improperly with respect to any security underlying the obligations of Webb & Knapp to the debentureholders. The debentures are and always have been wholly unsecured.

Finally, no claim is made by the Chapter X trustee that Marine Midland's alleged failure to ascertain or prevent Webb & Knapp's breach of covenant caused or contributed to the insolvency or bankruptcy of Webb & Knapp, nor does the trustee purport to state a cause of action on behalf of the estate of Webb & Knapp. Plainly he recognizes that Marine Midland's substantive obligations under the indenture were to the debentureholders and for their protection alone, rather than for the benefit or protection of Webb & Knapp or its other investors or stockholders.

C. The Debentureholders' Pending Actions

Two separate actions based upon the same allegations as those stated by the Chapter X trustee have been instituted by and on behalf of the debentureholders of Webb & Knapp and are pending against Marine Midland. One is in the Supreme Court of the State of New York, New York County, and the other is in the United States District Court for the Southern District of New York.[1]

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[1] The state court action is entitled

"DAVID RAY, on behalf of himself and all other present and former holders of the 5% Sinking Fund Debentures of Webb & Knapp, Inc., due June 1, 1974,

Plaintiff,

—against—

MARINE MIDLAND GRACE TRUST COMPANY,

Defendant."

The action pending in the Southern District of New York is entitled

"HARRY LEWIS, Suing both individually and as Chairman of the Webb & Knapp, Inc. 5% Sinking Fund Debenture Protective Committee, an Unincorporated Association, on behalf of all purchasers of 5% Sinking Fund Debentures due 1974, issued by Webb & Knapp, Inc. similarly situated, and ABRAHAM A. TUROFF,

Plaintiffs,

—against—

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK, HARRIS, KERR, FORSTER & CO., WILLIAM ZECKENDORF, B. A. TOMPKINS, ARTEMUS L. GATES, MAURICE ISERMAN, ARTHUR J. PHELAN, ARTHUR G. RYDSTROM, NICOLAS M. SALGO, ELLIOTT H. BINZEN, HERBERT I. SILVERSON, RUDOLF SMUTNY, JAMES A. VAN FLEET, ARNOLD M. GRANT, WILLIAM ZECKENDORF JR., EDWARD Y. BAUGEARD, JARED C. HORTON, ARTHUR T. ROTH, DAVID W. WALLACE, WILLIAM C. WARREN, JOSEPH P. BOHAN, HENRY R. BOSTON, O. HENRY BRIGGS, RONALD A. NICHOLSON, ROBERT B. ANDERSON, LEWIS W. DOUGLAS, THOMAS P. JERMAN, KENNETH A. KEITH, GRAYSON M. P. MURPHY, STUART F. SILLOWAY, HARRY V. LETT,

Defendants."

For the Court's convenience, copies of pertinent portions of the complaints in the *Ray* and *Lewis* actions are reprinted as part of the appendix to this brief.

Each of these actions is potentially broader in scope than the petitioner's representative suit.

First, each is brought on behalf of a broader group of plaintiffs than the group of present holders for whom the petitioner would sue. Ray sues for "all present *and former* holders" of the debentures, and Lewis sues for "*all purchasers*" thereof.

Second, the debentureholders' actions set forth additional allegations of fact and additional legal theories in support of their claims for damages. Thus, beside alleging negligent failure on the part of Marine Midland to prevent violation by Webb & Knapp of the assets/liabilities ratio prescribed by Section 3.6 of the indenture, *Ray* alleges culpable failure to accelerate maturity of the debentures upon the alleged happening of other defaults (A-9) and conflicts of interest (A-10). The *Lewis* complaint encompasses the material allegations of the complaints of both *Ray* and the Chapter X trustee (A-18 to A-19, A-13 to A-16) and further alleges violations by Marine Midland of Section 10(b) of the Securities Exchange Act of 1934 and of Rule 10b-5, which are not asserted by the Chapter X trustee. In addition, the *Lewis* plaintiffs have filed a motion for leave to amend their complaint to include claims based on alleged violations of the Trust Indenture Act, which also are not asserted by the Chapter X trustee.

Third, the *Lewis* action, which is grounded upon Rule 23, names many additional defendants in whose conduct Marine Midland is said to be implicated, including former officers and directors of Webb & Knapp and Webb & Knapp's accountants.

Notwithstanding the potentially broader scope of the *Lewis* and *Ray* cases, a decision permitting petitioner to

assert his claim necessarily would cut the heart out of those litigations or, if it did not, would subject Marine Midland to multiple and overlapping claims against it and expose it to double or triple recoveries on behalf of the same claimants.

The issue thus is cleanly framed: either the Chapter X trustee must preempt the debentureholders' class suits or his litigation role must be restricted to its traditional sphere of recovering property and asserting claims belonging to the debtor's estate. In the latter case, the alternative federal and state actions will go forward within the established framework of Rule 23 and parallel state procedures. The question is not simply one of the trustee's standing in the absence of any other claimants, but of whether the Bankruptcy Act or any other authority contemplates that if he should be moved to assert a representative claim for a group of creditors against a third party, his suit shall thereby sweep the field clean of other proceedings brought for the same group of claimants on the same causes of action under Rule 23 by members of these groups.

D. The Decision Below

The court below resolved the potential conflict between the petitioner and other litigants by adhering to the straightforward determination regarding a reorganization trustee's powers to sue which was first made by a court of appeals in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943), and has been followed thereafter by every court to which the question has been presented. After rigorous analysis of the provisions of the Act, examination of the precedents, and review of the underlying object of the Act, the Court *en banc* determined by a vote of 5 to 2 that the litigating province of the Chapter X trustee under the Bankruptcy Act is to pursue claims belonging to the estate

of the debtor which he is appointed to administer and not to divert his attention and the debtor's resources to the pursuit of property or claims belonging to others in which the debtor has no interest.

The Court of Appeals noted that "whether it is possible and, if so, desirable to go further and permit the trustee to enforce individual claims of security holders against third parties" is a "policy decision to be made by the legislature, not by our overruling soundly reasoned decisions of our distinguished predecessors, who knew the statute every bit as well as we do and construed it to mean what it rather clearly says" (App. 94a-95a). The court added that "with no showing that the *Clarke* decision has caused any real difficulty over the past twenty-seven years, Congress might well decide that it was best to adhere in the policy of allowing holders of bonds of debtors in reorganization to pursue their own remedies against third parties" (App. 95a).

Since the present action admittedly is not based on any claim belonging to the debtor or related to property of the debtor, the court upheld the decision of the District Court dismissing the petitioner's plenary action and counterclaim.

Summary of Argument

The basic argument advanced by the petitioner and supported by the Securities and Exchange Commission is founded ultimately on out-of-context snippets from the legislative history of Chapter X referring to the need for an "independent trustee" in reorganization proceedings for the "protection of investors."

As shown more fully hereafter, the legislative history relied upon by petitioner is utterly unrelated to the issue presented on this appeal. House and Senate reports alike, the underlying SEC study, and the testimony cited by petitioner

are all directed to the need for establishment of an independent trustee "as the focal point for formulation and negotiation *of a plan of reorganization*"[2] and to provide "adequate representation" of security holders "*in the* [reorganization] *proceedings*"[3] (emphasis added). There is not the slightest suggestion anywhere in those sources that the reorganization trustee has been granted power to prosecute claims for damages against third parties for the private benefit of sub-groups of security holders or creditors of debtors in reorganization where no part of the recovery would benefit the estate. The legislation enacted by the Congress on the strength of the evidence presented to it granted no such powers, as the court below and its predecessors have consistently held over the years, nor can such powers sensibly be thought to be implicit in the statute's scheme or "in keeping with the underlying purpose of Chapter X" (SEC Br., p. 10). The Bankruptcy Act is extraordinarily explicit in defining the precise causes of action which may be asserted by a reorganization trustee (Sections 70(a)(5) and (6), 11 U.S.C. §110(a)(5), (6)) and does not encompass the kind of claim which the trustee seeks to assert in this case.

Moreover, the power contended for by the trustee is altogether inconsistent with the legal framework carefully developed over the years for the prosecution of class actions on behalf of security holders and others. Under the petitioner's theory, once a Chapter X trustee embarks upon his duties and acquires some familiarity with a debtor's affairs, he becomes the single appropriate party to sue on behalf of persons who may be or may have been "investors" in the

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[2] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 44.

[3] Hearings Before the Committee on the Judiciary, House of Representatives, 75th Congress, 1st Session, on H.R. 6439 subsequently amended and reported as H.R. 8046, June 1-4, 8, 9, 1937, at 163.

debtor, if he thinks they may have been wronged in any fashion by a third party. Once he sues, class actions prosecuted by aggressive and experienced members of the stockholders' bar apparently would be precluded and the balanced mechanism of Rule 23 presumably ignored.

In the present situation, all of the lower courts which have dealt with the problem have found a boundary between a trustee and other suitors necessary, and all have maintained the same limitation: the trustee's standing to sue is and should be confined to the pursuit of claims belonging to the debtor's estate. This is the limit set by Congress, and it is one which properly divides the trustee's status as a litigant under the Bankruptcy Act from the status of representatives selected under the provisions of Rule 23 and state equivalents.

ARGUMENT

I. The Petitioner lacks standing to prosecute a damage suit for debentureholders against a third party in which the recovery, if any, would benefit the debentureholders alone and affect neither the estate of the debtor nor a plan of reorganization.

A. The Bankruptcy Act defines the Chapter X trustee's powers entirely in terms of his succession to the debtor's title to specified kinds of property.

The provisions of the Bankruptcy Act which define a Chapter X trustee's powers and duties leave no ambiguity as to their source and extent. In specific application, as in theory, they derive entirely from the trustee's succession to title to the debtor's estate. While the Congress undoubtedly contemplated that these broad powers would in fact protect the interests of a debtor's public investors, the Bankruptcy Act which it authored makes clear the precise ways in which this is to take place. Protection of investors

was a Congressional goal, but the Bankruptcy Act—specifying recoupment of the debtor's assets—is the blueprint for the trustee's role in its achievement.

The title, rights, powers and duties of a trustee in reorganization are described in the first instance by Sections 186 and 187 of the Bankruptcy Act and, so far as concerns a trustee's title to property or causes of action and his right to assert claims, they are more particularly specified in Sections 47(a) ("Duties of Trustees"), 60 ("Preferred Creditors"), 67 ("Liens and Fraudulent Transfers"), 70(a) ("Title to Property"), and 167(3) (concerning the reporting of causes of action "*available to the estate*"). Since there is no allegation here of preferential or fraudulent transfers or liens, Sections 60 and 67 are of no importance in this action.

Sections 186 and 187 provide as follows:

> "Sec. 186. A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.
>
> "Sec. 187. Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor."

The title acquired by a trustee appointed pursuant to Section 44 is set forth in painstaking detail in Section 70 of the Act. It provides in pertinent part as follows:

"Sec. 70. Title to Property. (a) The Trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act . . . to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor . . . (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this Act, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court."

Nothing whatever in the foregoing provisions suggests that the trustee succeeds to rights of action which belong to

third parties. Specifically, the trustee is vested on appointment with the *title of the bankrupt* to specified kinds of property, none of which has the slightest relation to the right of action which the trustee claims to assert here.

Specific provisions of the Act such as Section 70(a)(5) and (6) are expressly addressed to the matter of title to rights of action, and they particularize the litigation rights to which the trustee succeeds; but they pointedly do not embrace specifically or by description the right of action asserted here. It therefore seems patent that the trustee was not intended to be granted any such title.

The duties of a trustee appointed pursuant to Section 44 are set forth in similar detail in Section 47(a). So far as concerns the Chapter X trustee's standing to assert the claim made in the plenary suit and by counterclaim in the reorganization proceedings, only the following passage appears to be pertinent:

> "Sec. 47. Duties of Trustees. (a) Trustees shall (1) collect and reduce to money the *property of the estates* for which they are trustees . . ." (Emphasis added.)

With specific reference to Chapter X, Section 167 provides:

> "Sec. 167. The trustee upon his appointment and qualification—
>
> • • •
>
> "(3) shall report to the judge any facts ascertained by him pertaining to . . . any causes of action *available to the estate* . . ." (Emphasis added.)

Again, nothing here imposes a duty or grants power to attempt to collect a claim which is not the property of the estate, but of third-party claimants against the estate.

The order appointing the petitioner as a Chapter X trustee granted no greater powers to him than those contemplated by the statute. So far as relevant here, Order No. 3, dated May 18, 1965, directed that

> "5. The Trustee shall be vested with the title to all the *property of the Debtor*, of whatever kind and wherever located; and shall be vested with all the rights, powers and duties of a trustee appointed under Chapter X, and, when not inconsistent therewith, of a trustee appointed under Section 44 of the Bankruptcy Act; and shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the *property of the Debtor*.
>
> • • •
>
> "7. Without limiting in any way the generality of the foregoing provisions of this order, the Trustee is specifically authorized:
>
> • • •
>
> "(h) To collect and receive all revenues, rents, issues, income, and profits, and all outstanding accounts, choses in action, and credits *due or becoming due to the Debtor*;
>
> • • •
>
> "(n) To institute, prosecute, defend, compromise, intervene in, or be substituted as a party in any suit, action, or proceeding, at law or in equity or in courts of bankruptcy, in State or Federal courts either within or outside of the Southern District of New York, or before any State or Federal administrative agency, as he may deem necessary or proper for the protection or *preservation of the Debtor's property*;
>
> • • •

> "(p) To do any and all said things, and to make such payments and disbursements out of the property and assets of the estate as may be needful or expedient for the preservation, protection, maintenance, or operation of *the Debtor's property, assets, and business.*" (Emphasis added.)

It is apparent that both the applicable statutory provisions and the order of May 18, 1965 are directed to the collection, protection and preservation of the debtor's property wherever located, including causes of action belonging to the debtor. Neither refers to the pursuit of claims of third parties which do not belong to and have never belonged to the debtor.

Neither the Bankruptcy Act nor Order No. 3 confers upon the Chapter X trustee either the title or the right, power, or duty to maintain the claim alleged in these pleadings on behalf of debentureholders, who in any event are demonstrably eager and able to protect themselves.

Against the express language of the Bankruptcy Act, the trustee erects and the belabors a vague, ill-defined theory of "investor protection" which features general quotations shifted subtly from their original reference to the preservation of a debtor's estate (in which investors of course have an interest) to the implication that the trustee alone is authorized "to investigate and enforce *all* claims of investors and creditors" (Pet. Br. 9; emphasis added). The petitioner cites in support of this theory (i) remarks of then-Commissioner Douglas of the Securities and Exchange Commission in support of the enactment of the bill which became the Chandler Act (Pet. Br. 9-10), and (ii) an excerpt from a House Report on that bill (Pet. Br. 10-11).

The material quoted is not remotely directed to the issues before this Court and, after all is said and done, the simple fact remains that the Act, as ultimately enacted by the Congress, particularizes in fine detail the powers of the trustee and the causes of action to which he acquires title, but does not grant the power to sue on claims belonging to third parties.

Taking the materials cited by the petitioner in support of the supposed "Congressional scheme" to set up an omnipotent trustee in the order in which they are advanced, it should be emphasized that (a) the legislative history of the Chandler Act nowhere refers to the idea of a trustee's suit outside his role as protector of the estate; (b) references to the Trust Indenture Act of 1939 are window dressing, because the respondent's duties pursuant to that Act are not in issue in this suit, in which petitioner's complaint attempts to assert no claim whatsoever under that Act; and (c) the triad of remedies adopted by Congress in 1938-39 to protect public investors listed in petitioner's brief (Pet. Br. 13) fails to include a significant fourth remedy of 1938, the class action device codified in Rule 23 of the Federal Rules of Civil Procedure in that year.

In the first place, a thorough reading of the legislative history cited by petitioner reveals it to be unpersuasive in supporting his position. Certainly, one of the objects accomplished by the Chandler Act was the creation of the independent trustee; but in concluding its discussion of his role, the House Report on the Chandler Act cited by petitioner summed up (on the very same page he cites) the reasons for its necessity:

> "Under the bill the independent trustee will serve as *the focal point for formulation and negotiation*

> *of a plan for reorganization.* This important function under the present system has been left to the inside few. That normally has meant leaving it to the management and the investment bankers. It should no longer be left in these hands since those persons too often have interests conflicting with those of investors."[4]

As a reading of the Report makes clear, the independent trustee's office was created so that a neutral, detached party would control the debtor's reorganization itself. The trustee was to tip the scales to a proper balance of power in bankruptcy proceedings between the debtor on one side and investors and creditors on the other.

This is far removed from any implication in the legislative history which would support the idea that Congress ever contemplated that the trustee might prosecute damage suits against third parties on behalf of a group of creditors when no part of the prospective recovery would benefit the debtor's estate. The indisputable fact that the Chandler Act was drafted with the point of view of the investor in mind means no more than that the independent trustee, rather than the debtor or the persons who had formerly acted on its behalf, is now the one who presides in formulating the plan of reorganization, proposes the reorganization plan to the court, and basically manages the reorganization proceeding as an arm of the court.[5] Petitioner points to nothing in the history of the Act which sanctions the trustee's

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[4] H. Rep. 1409, 75th Cong., 1st Sess. (1937), 44 (emphasis added); compare petitioner's brief at pp. 10-11.

[5] *See id.* at 42-44; Hearings Before the Committee on the Judiciary, House of Representatives, 75th Cong., 1st Sess., on H. R. 6439 subsequently amended and reported as H. R. 8046, June 1-4, 8, 9, 1937, p. 376.

proposed diversion from his duties as reorganizer to the additional role of volunteer prosecutor of creditors' personal claims which are not assets of the debtor.

Secondly, the petitioner's references to the Trust Indenture Act are even less apposite. *Other* litigants suing Marine Midland have contended in an action brought pursuant to Rule 23 that the respondent has violated this Act; but the petitioner himself makes no such allegation. Instead, the implied attempt to cast his theory of standing momentarily in the guise of a special right of a Chapter X trustee to sue an indenture trustee—a notion not even remotely supported by the Bankruptcy Act or the Trust Indenture Act—is camouflage masking the true nature of his grandiose claim to be the only proper enforcer of *all* claims of investors and creditors (Pet. Br. 9), however they may arise.

Finally, as is set forth more fully herein, the petitioner omits Rule 23 entirely from his catalogue of measures enacted by Congress for the protection of investors and invokes supposed dilemmas long since solved by that rule.

In summary, the Bankruptcy Act clearly enumerates the trustee's powers, which do not include the preemption of investors' own suits for their "protection" but instead are limited to the preservation of the debtor's estate and the formulation of a plan of reorganization for the benefit of all investors and creditors of a debtor.

B. The statutory limitation of the trustee's litigation authority to the recovery and preservation of the property of the debtor is neither "narrow" nor "hypertechnical."

In his brief, the petitioner seeks to portray the judgment of the Court of Appeals in this case as erroneous and atypical by describing the distinction drawn there between suits

which a Chapter X trustee may maintain and those which he may not as "narrow" and "hypertechnical" (Pet. Br. 22). He contends that an attempt to distinguish between actions based on pursuit of the debtor's assets and all other sorts of claims is excessively rigid and formal, and that it stands in the way of appropriate concepts of investor protection.

The contours of this argument reveal the flaw in the petitioner's position on this appeal. Were he seeking simply a clarification or even a moderate extension of a Chapter X trustee's litigation authority, he might appropriately urge a reformulation of the boundaries of his duties in principled terms in order to prevent lower courts' errors.

But this is not what the petitioner attempts at all. It is impossible to glean from his brief any definition whatever of what he considers to be the *proper* limits to be placed upon a trustee's powers to assert claims as the single appropriate representative of groups of which he is not a member and which do not claim that the rights in question arise in any way out of the debtor's property which he protects. In fact, he seems to envisage no limits.

The petitioner's argument does not attempt to portray the claims in issue as property of the debtor's estate in any sense, for this is impossible. Instead, it is a broadside attack upon the idea that protection of the debtor's property—stigmatized as a "hypertechnical" or "niggling" notion (Pet. Br. 17) in spite of its universal acceptance and application heretofore—should be a limit at all. The argument runs as follows: (a) the very idea of a "res" belonging to the estate is a narrow concept which serves no useful purpose; (b) the trustee has assembled extensive files of all sorts; (c) the debentureholders of Webb & Knapp are investors and are part of a group intended by Congress to

receive the benefits of a variety of protective statutes; and (d) therefore the trustee ought to be permitted to use information in his files on their behalf.

The problem inherent in this form of argument, in addition to its refutation in section after section of the Bankruptcy Act, is that it never addresses the questions of why the limits of the debtor's property are no longer appropriate under present conditions or what boundary notions are suggested to replace them.

Presumably the petitioner would not press his theory to the limits implicit in his present statement of it, i.e., that he is or should be deemed to be authorized by the Bankruptcy Act to serve as the exclusive enforcer of *all* claims of investors against third parties about which he has information. For example, if a large group of the debentureholders had been gulled into buying their Webb & Knapp debentures on the open market by glowing false statements about the company made knowingly or recklessly by a securities analyst unaffiliated with the company, would the trustee contend that his subsequent knowledge of the true state of Webb & Knapp's affairs made him the only appropriate claimant on their behalf? Could he maintain a securities fraud action as their representative against accountants or even lawyers against whom Webb & Knapp itself had no claim but who had played a role in the analyst's touting?

It is assumed that the petitioner's argument is not intended to extend this far. Likewise, he presumably would not argue that he is the statutory class representative of any members of the existing Webb & Knapp debentureholders' protective committee who assemble for a meeting in his presence and suffer some sort of tortious injury there at the hands of a third party. Surely he would admit that any personal claims of investors which he is allowed to preempt for

litigation purposes are confined to those having some appropriate nexus with the debtor's estate which the trustee protects.

But once this is admitted, it becomes difficult to define any nexus more appropriate than—or even separate from—the status of the claim as a part of the property of the estate. Any other formulation (of which the petitioner suggests none) would be reduced to an *ad hoc* rule of no rule at all, a case-by-case determination that given claims either are or are not sufficiently close to the core of the trustee's true responsibilities vis-a-vis the debtor's property to allow him to preempt them. No matter how it is stated, the petitioner cannot escape the fact that the vast bulk of any trustee's duties are confined to preservation of the debtor's assets, and any extension of his powers as a practical matter must be defined in terms of an expansion outward from this core.

A few of the cases cited by the petitioner do involve some extensions outward from the core. For example, in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), the Court held that an equity receiver could assert a claim to recover diverted assets of the debtor by suing in the name of its creditors, whereas the debtor itself would have been barred from suing by complicity in the fraud.[6] But in every such case, as in *McCandless*, the property in question was a part of the estate and the extensions were devised to enable a trustee or equity receiver to overcome some formal barrier to its preservation or recovery for the trust. *See, e.g.*, *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2d Cir. 1939).

In the present case, however, the petitioner cannot even begin to bring himself within any such principle. Instead,

[6] This case is discussed more fully at p. 35, *infra*.

he presents a direct attack upon the very idea of any limiting concept governing his powers, based upon a claim which belongs entirely to the debentureholders and not to the estate. Consequently, the argument he maintains cannot be subjected to close scrutiny without revealing that it proposes a radical departure from previous thinking in this area of the law.

We have argued above that there is no basis for such a departure in the legislation which the petitioner invokes. In addition, this new role for the Chapter X trustee could not in any beneficial way affect his own basic duty, planning the debtor's reorganization; and still further, it is unsupported by any previous case dealing with the powers of either a trustee or an equity receiver.

C. Any recovery on behalf of the debentureholders will not affect the trustee's plan of reorganization for Webb & Knapp.

In his brief, the petitioner takes the position that the Court of Appeals was "simply wrong" in observing that any recovery by or on behalf of the debentureholders against Marine Midland would not affect the trustee's formulation of a plan of reorganization (Pet. Br. 23). Petitioner's argument, however, fails altogether to deal with the principal point made by the Court of Appeals in this regard (App. 92a) and is itself "simply wrong" in its analysis of that Court's reasoning with respect to subrogation (App. 91a-92a).

As to the main point, petitioner does not answer the Court of Appeals' adoption (App. 92a) of Judge A. N. Hand's observation in *Clarke, supra,* 137 F.2d at 800, that

> "Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants."

In short, the claim against Marine Midland could not be prosecuted to judgment until the results of the reorganization become known.

The point may be illustrated by an example. Suppose the debtor's estate was sufficient to pay off the debenture-holders at 100 cents on the dollar. Obviously no claim could be asserted in such circumstances against Marine Midland, even if it had failed, as alleged, to enforce some covenant in the indenture; for there would be no damage. The principle involved is no different if the amount ultimately available for distribution is 75 cents, 50 cents, or, as in the present case, 4 cents on the dollar. Damages, if any, cannot be measured until the distribution ultimately is made. Only then can it be known what the debentures held are worth, and only then can it be known what the damages sustained have been, if any.

Talk of the "practical dynamics of bankruptcy reorganization," which petitioner says the Court of Appeals "failed to appreciate" (Pet. Br. 31), does not meet the point. It is hardly likely that adequately informed debentureholders would be agreeable to a plan of reorganization which deprived them of their fair share, with other unsecured creditors, of any distribution from the debtor's estate and gave in exchange only an undertaking by the trustee to pursue a cause of action on their behalf against third parties. Nor is it reasonable to think that a plan could be found to be "fair and feasible" and thus be confirmed if

it provided that the debentureholders' share of the distributive estate would consist solely of the services of the Chapter X trustee to pursue a naked chose in action on their behalf. Under existing class action procedures, the debentureholders could and should have it both ways, i.e., they have a right to a certain distribution which is their share of the bankruptcy estate plus a chance themselves to pursue an ordinary class action for the balance.

In any event, as the Court of Appeals found, if some device were fabricated by which debentureholders were deprived of their distributive share of the debtor's estate in favor of a claim against Marine Midland, the latter would in all likelihood have a right of subrogation and be entitled thereby to participate in the distribution, leaving the plan unaffected. Petitioner's argument to the contrary is this: subrogation might be denied to a party held liable to the debentureholders for the face value of their securities, so that the debentureholders would be satisfied in full and their claims against the Webb & Knapp estate would be withdrawn. As a result, additional funds would remain for distribution to the other creditors, and the plan of reorganization would be affected accordingly.

In fact, this argument is built upon sand because of the true nature of the debentureholders' claims against Marine Midland: although they have been stated in pleadings in terms of wrongdoing and "gross" negligence, these claims in fact are essentially charges that Marine Midland "*ought* to have known" of Webb & Knapp's alleged breach of its covenant regarding the assets/liabilities ratio to be maintained and ought to have rejected as false the officers' certificates of compliance delivered to it pursuant to the terms of the indenture and upon the terms of which it was entitled to "exclusively rely." Under the circumstances, any ulti-

mate finding of liability on the part of Marine Midland would be likely to require a radical reinterpretation of the responsibilities of all indenture trustees and, in any event, almost certainly could not involve the type of culpability which sometimes leads to a denial of subrogation rights.

But in any case, the subrogation and measure of damages issues are now not only hypothetical but virtually moot. A plan of reorganization has already been submitted for Webb & Knapp by the petitioner, involving a distribution of approximately four cents on the dollar to unsecured creditors, including the debentureholders. The plan has been approved by the Securities and Exchange Commission with only minor modification suggestions and is presently before the District Court.[7] Once the plan is consummated, any damage claim on behalf of the debentureholders will be fixed at the difference between the ultimate value of their securities (four cents on the dollar) and their principal value. Any further recovery on the debentureholders' behalf from third parties such as Marine Midland would be wholly apart from and subsequent to the reorganization plan, so that it literally could not affect that plan.

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[7] A copy of the Memorandum of the Securities and Exchange Commission on the Trustee's Proposed Plan of Reorganization, filed in the Reorganization Court January 27, 1972, has been lodged with the Clerk of this Court. That memorandum recommends an amendment to the plan to make absolutely clear that

> ". . . unlike the other claims and causes of action, any fund that may be recovered by the Trustee in the *Caplin* v. *Marine* litigation will inure solely to the benefit of the debenture holders.
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> * * *
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> "A Chapter X plan is, among other things, a disclosure document. It should be a good one, and it ought to be at least as informative as a prospectus or proxy statement meeting the requirements of the securities laws. In our view, this Plan does not meet that standard. The obscurity of its discussion of the action against Marine Midland Bank could mislead some of the estate's general creditors." (pp. 14-15)

This development illustrates the tenuousness of the petitioner's statutory standing argument. The question of whether or not recovery by outsiders would affect the reorganization plan in any given case would depend in any event upon the fortuity of its timing. Presumably the presentation of a plan should not be made to wait upon the vagaries of the trustee's efforts to pursue claims on behalf of subgroups of creditors, as the petitioner's own decision to proceed with the Webb & Knapp plan shows.

No such conflict between the problems of delays which might occur in third-party litigation and the need for prompt development of a plan of reorganization could arise if the trustee were clearly understood to lack standing to pursue the debentureholders' personal claims.[8]

D. The courts have consistently held that a Chapter X trustee has no standing to prosecute claims of the kind asserted in this case.

Judge Friendly's opinion below includes an extensive analysis of the leading cases involving a Chapter X trustee's ability to assert claims on behalf of the debtor's debentureholders, in which he points out their unanimous consensus regarding the appropriate boundary for this power. As the Court of Appeals held, this authority has been limited previously in *every* Chapter X case to recovery of property of the debtor.

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[8] Although parallel issues have been posed by the trustee's objection to Marine Midland's proof of claim in the reorganization court, it is extremely unlikely that questions of this magnitude actually will ever be litigated in any "full presentation" in this context (Pet. Br. 20). Marine Midland's total claim, if pressed, would be worth only some $2,000 at the unsecured creditors' distribution rate of four cents on the dollar, as set forth in the Webb & Knapp Plan of Reorganization.

In addition, examination of the cases relied upon by the petitioner involving the powers of an equity receiver reveals that in this respect the limits upon the receiver's standing correspond precisely to the standing limitation upon trustees under the Bankruptcy Act.

1. *Chapter X trustee cases*

Petitioner bases his claims of precedent with regard to his status as statutory trustee upon an analysis of three previous cases which reached the federal appellate level.

The facts of the first of this trilogy, *Clarke* v. *Chase National Bank*, 137 F.2d 797 (2d Cir. 1943), are set forth in Judge Friendly's opinion below (App. 87a-89a). On motion to dismiss counts based on allegations remarkably similar to those now before the Court, the Second Circuit held that a Chapter X trustee did not have standing to assert claims on behalf of debentureholders against an indenture trustee where the latter failed to prevent the debtor from violating negative covenants of the indenture.

In *Clarke*, the Second Circuit clearly marked the divide between standing and no standing by distinguishing counts alleging failures to prevent breaches of covenants from counts alleging self-dealing by the indenture trustee or preferential transfers to itself.

Where a preference or self-dealing was alleged, the court upheld the Chapter X trustee's standing to sue because the recovery and application of such preference money would enlarge the estate of the debtor and thus affect the relative participations of the indenture trustee, the debentureholders, and all other claimants against that estate in the plan of reorganization (p. 801).

In contrast, the Court could not "see that the claims for breach of the covenants are any part of the property of the bankrupt or would affect the plan of reorganization. They at most would be a claim of the debentureholders not derived from the bankrupt's estate but arising through the alleged tortious action of the indenture trustee" (p. 800).

The case turned upon the distinction between causes of action alleging culpable failure by the defendant indenture trustee to prevent breaches of negative covenants barring, among other things, issuance of senior debentures, and causes of action alleging preferential payments to and self-dealing by the indenture trustee. The Second Circuit dismissed the former—analogous to the claims asserted here—as personal to the debentureholders and allowed the latter, which involved prospective recovery of property for the benefit of the debtor's estate.

Petitioner asked the Second Circuit to overrule its decision in *Clarke* and to adopt the dissenting opinion of Judge Learned Hand, who had found the claim of failure to enforce negative covenants prohibiting the corporate rearrangements in which the indenture trustee did *not* participate nevertheless to be property of the debtor's estate.[9] He reasoned that an indenture trustee's naked chose in action against a debtor for failure to enforce a negative covenant of the debtor expressed in an indenture is a "res," held in trust for the debentureholders. Also, property of the debtor delivered into the hands of an indenture trustee

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[9] The opinion of Judge Hand on which petitioner relies attempted to deal with the problem as one of defining the boundaries of the debtor's estate rather than simply abandoning this concept as would the petitioner. *Compare* Judge Hand's opinion in *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F.2d 130, 131-32 (2d Cir. 1939).

as security for payment of the debentures is a "res," held in trust for the debentureholders. Since the chose in action is thus a trust "res" and the debtor's property as security is also a trust "res," Judge Hand concluded that they are equivalent to one another and that, if either is wrongfully released by the indenture trustee, "it is a proper part of a reorganization to compel a[n] [indenture] trustee to restore the fund to that amount which it would have had had he not been derelict in his duties."

The reasoning, of course, is tautological—"res" equals "res." The conclusion drawn, however, does not follow. The two kinds of trust "res" identified by Judge Hand are equivalent only to the extent that debentureholders may have an interest in both the enforcement of the chose in action against the debtor and in retention of property delivered by the debtor as security for payment of outstanding debentures. Debentureholders may have causes of action against the indenture trustee for releasing either. The two types of trust "res" are *not* equivalent, however, from the point of view of the Chapter X trustee, whose proper interest and power is limited to recovery of the debtor's assets. Judge Hand's reasoning goes awash when he states that, whichever res is released, "the loss was nevertheless of the debtor's assets; the remedy will be in their restoration" (p. 802). This is not so. The "loss" which was the subject of the negative covenant counts in *Clarke* was not of "debtor's assets," but of a chose in action against the debtor, belonging to the debentureholders; their remedy was not restoration of "debtor's assets," but damages payable to them by the indenture trustee.

The majority in *Clarke* and the *en banc* majority of the Second Circuit in this case rejected Judge Hand's analysis

on the foregoing basis, by pointing to the totally different nature of the rights involved. The claimed loss of debentureholders' rights to have negative covenants enforced is not "equivalent to" property held in trust for the debtor, because it never constituted part of the debtor's assets and had a totally different origin in a contract between the debentureholders and their indenture trustee. Accordingly, it is not the province of the Chapter X trustee to pursue the matter.

To state this conclusion is not to beg any question, but simply to invoke and follow the terms of the Bankruptcy Act, which requires a trustee to collect the "property of the estate" (Section 47). It is no more conclusory than the statute.

Subsequently, Judge Learned Hand wrote the opinion for the majority on rehearing in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F.2d 555 (2d Cir.), *cert. denied*, 346 U.S. 835 (1953). In that case Judge Hand himself distinguished between two forms of guaranty obligations which allegedly were not enforced by the indenture trustee, allowing a Chapter X trustee to sue *only* for the one which arose out of a right which was clearly a part of the debtor's estate. The petitioner does not dispute this reading of the case directly, but instead denounces Judge Friendly's exposition of this distinction (App. 90a-91a) as "agonizing" and as a "sleight-of-hand." The petitioner then lapses into a digression, injecting once again the tacit assumption on which his appeal is based—the suggestion that no one else will "effectively" assert any claim with respect to which the petitioner trustee lacks standing if he does not (Pet. Br. 25).

Moreover, the petitioner overlooks one key point about the *Prudence-Bonds* situation. As shown in *Brooklyn Trust Co.* v. *Kelby, et al. In re Prudence Bonds Corporation*, 134 F.2d 105 (2d Cir. 1943), the "new company" whose standing to sue on behalf of bondholders was in issue in the *State Street Trust Co.* case in fact was no outside representative but actually nothing more than the bondholders collectively and exclusively. As stated by Judge Frank,

> "In 1938, the bankruptcy court entered an order approving separate plans for each of the "series" of bonds and a "general" plan for the debtor, the court having found that there was no "equity" for the debtor's general creditors or stockholders. Under the "general" plan, a new company was to be created; its stock was to be placed in a voting trust, all the voting trust certificates to be distributed pro rata among the bondholders; the debtor and trustees in bankruptcy were to transfer all their interests to this new company which was liable on all its bonds." *Id.*, at 108.

In short, the *State Street Trust Co.* suit, brought nominally by the "new company" as successor to the debtor and the trustee, was a suit solely by and for the bondholders and no one else. There was in effect no intervening representative suing on their behalf for they *were* the "new company," as the Second Circuit very well knew when it decided the matter of standing.

Finally, petitioner refers briefly to the Third Circuit Court of Appeals' holding in *In re Solar Mfg. Corp.*, 200 F.2d 327 (3d Cir. 1952), *cert denied*, 345 U.S. 940 (1953). In that case, too, a Chapter X trustee's standing was based on his allegations that the indenture trustees had received preferences, or had mishandled security or other funds to

be held by them for the bondholders, or were guilty of self-dealing to the detriment of the bondholders. The case is not "flatly inconsistent" with the decision below, as petitioner charges (Pet. Br. 26), but is instead perfectly consistent, as Judge Friendly's opinion points out (App. 91a, n. 4). The court of appeals for the Third Circuit explicitly determined in *Solar* that its decision was consistent with the earlier decision of the Second Circuit in *Clarke*.

2. *Equity receivership cases*

Pursuant to Section 187 of the Bankruptcy Act, the order appointing the petitioner as Chapter X trustee granted him powers, in addition to those contemplated by the statute, which a receiver in equity would have if appointed by the court.[10] *See generally* 6A Collier, *Bankruptcy* ¶ 8.08, at 34 (Rev. ed. 1971). Even in these circumstances, however, an equity receiver acquires

> . . . no greater or superior right or interest in the property coming into his hands than the debtor had and in which relation may be said to stand in the shoes of the debtor; and, furthermore, as a general rule the receiver takes the property in the same plight and condition, and subject to the same equities and liens, as he finds it in the hands of the person or corporation out of whose hands it is taken."

Black v. *Manhattan Trust Co.*, 213 F. 692, 693 (D. Ore. 1914). *See Moviers* v. *Lee*, 30 F. 298 (N.D.N.Y. 1887); *Roeblings Sons Co.* v. *Frederickson Logging & Timber Co.*, 153 Wash. 580, 280 P. 93 (Sup. Ct. Wash. 1929). The rule has been similarly stated in a leading receivership treatise:

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[10] This was also the case in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (2d Cir. 1943).

> "The ordinary equitable non-statutory receiver of an insolvent corporation makes his title (whatever title that is, either equitable or otherwise) through the corporation. He cannot through his appointment acquire that which the corporation never had. He represents the creditors of the corporation in the administration of his trust, his trust relates only to the corporate assets."

3 Clark, *Receivers* §362, at 619 (3rd ed. 1959).

The petitioner and the Securities and Exchange Commission both invoke exceptions to this rule, relying heavily in their briefs (Pet. Br. 14; Sec. Br. 23) on the Court's opinion in *McCandless* v. *Furlaud*, 296 U.S. 140 (1935), in support of the proposition that equity receivers have standing to sue third parties on behalf of bondholders without limitation. In *McCandless*, however, the receiver's claim involved *property of the debtor* which the debtor itself could not sue to recover because it would have been barred by the defense of consent or estoppel. Mr. Justice Cardozo took care to point this out in the concluding paragraph of his opinion, which completely rebuts not only the dissent in that case and the dissent below in this one, but also negates any reliance on this opinion by the petitioner and the Securities and Exchange Commission:

> "As we have striven to make clear, the receiver does not claim to have succeeded to the rights of the bondholders or noteholders to recover damages for deceit. The wrong that is here redressed is the unlawful depletion of the assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies." 296 U.S., at 167. See Note, *Rights of Creditors of Insolvent Corporations—Greater Than Rights of Corporation*, 34 Mich. L. Rev. 1196 (1936).

Although the receiver sued formally in the name of creditors in order to invoke rights superior to the defense of estoppel against the corporate debtor, the rationale of the case is perfectly consistent with that of *Clarke* and the present action. Here the receiver is asserting creditors' claims which are wholly separate from the debtor's property and which, upon recovery, would not replace any assets which may have been unlawfully depleted.

The object of an equity receivership is to collect all assets of the debtor and distribute them among such creditors as have valid claims. *See, e.g.*, 2 Clark, *supra*, §578 at 943.

In this case, the trustee in his status as receiver is not bringing suit to collect an asset of the debtor, but instead is asserting a claim against a third party on behalf of the debtor's bondholders who themselves could bring suit. A receiver's power in equity has never been held to extend so far.[11]

E. The trustee is not the real party in interest.

In both its opinion in this case (App. 93a) and in the *Clarke* case, the Second Circuit held that the Chapter X trustee was also barred from asserting the debentureholders' claims by F. R. Civ. P. 17 (a), which is applicable in this case by virtue of General Order in Bankruptcy 37. Rule 17(a) requires that "Every action shall be prosecuted in the name of the real party in interest"; and since the

[11] This general rule is not contradicted by the cases collected in Note, *Power of Receiver for Corporation to Assert Causes of Action Vested Solely in Creditors*, 46 Yale L.J. 1229 (1937). The note suggests the possibility of a rule akin to the petitioner's position as a beneficial but "radical departure from" then-current equity practice—"beneficial" *because of defects in the class action mechanism of that day. Id.*, at 1234, n. 32; *see id.* at 1233-34. These defects have long since been remedied by the promulgation and subsequent amendment of F.R. Civ. P. 23.

trustee has been authorized by the Bankruptcy Act only to collect and reduce the property of the estate, he is not the real party in interest in any suit upon the debenture-holders' personal claims.

The "real party in interest," is the person "who, by the substantive law, has the right sought to be enforced." *Rock Drilling and Common Laborers' Local Union No. 17* v. *Mason & Hanger Co.*, 217 F.2d 687 (2d Cir. 1954), *cert. denied*, 349 U.S. 915 (1955). Except where a federal right is involved, the governing substantive law is the law of the state in which the federal district court sits. See 3A Moore, *Federal Practice* ¶ 17.07 at 224 (2d ed. 1970); 2 Barron & Holtzoff, *Federal Practice and Procedure* §482 at 7-8 (Wright ed. 1961).

As we have shown above, neither the provisions of the Bankruptcy Act, the terms of the order appointing the present Chapter X trustee, nor the pertinent decisions afford the slightest basis for any contention that the Chapter X trustee has standing (or proper interest) as a matter of right under federal law to assert the claim set forth in the pleadings before the Court. In *Clarke, supra*, the Court allowed the trustee to proceed with the causes of action for recovery of certain preferences as assets of the estate. However, regarding claims alleging failures to enforce negative covenants made solely for the benefit of the debentureholders, the Second Circuit said:

> "[T]he trustee in bankruptcy has no title to the claims embraced in the first and third counts and is not the real party in interest by whom such claims should be asserted under Rule 17(a) of the Rules of Civil Procedure, 28 U.S.C.A. following section 723c. Elkind v. Chase National Bank, 259 App. Div. 661, 20 N.Y.S. 2d 213, affirmed 284 N.Y. 726, 31 N.E. 2d 198." *Id.* at 801.

So also in the case at bar the Chapter X trustee has no claim to any right of action on behalf of the debentureholders against Marine Midland. The right to prosecute any cause of action on behalf of the debentureholders against Marine Midland is and always has been owned entirely by the debentureholders, and they are the only real parties in interest by whom such claims can be asserted under Rule 17(a).

The New York law appears to be the same. In *Barnes* v. *Hirsch*, 215 A. D. 10 (1st Dept. 1925), *aff'd mem.*, 242 N.Y. 555, *cert. denied*, 273 U.S. 709 (1926), where creditors of a bankrupt sought to assign certain tort claims to the trustee, the court held:

> "A trustee in bankruptcy has only such title and power as given by the Bankruptcy Act. He is a creature of that statute. No serious assertion is made here that these claims, indicated by the complaint, were property of the bankrupt. They were not assets which passed to the trustee because they belonged to the bankrupt." 215 A. D., at 13

Accord, Rock Drilling and Common Laborers' Local Union No. 17 v. *Mason & Hanger Co., supra:*

> "The causes of action which the trustee has by reason of the Bankruptcy Act, other than such as were property of the bankrupt, are causes of action to recover or follow assets."

It has been amply shown above that the alleged cause of action here cannot have been "property of the bankrupt" under any view, nor is it claimed that the action which the Chapter X trustee seeks to bring is "to recover or follow assets" which once belonged to the debtor.

II. The debentureholders are capable of asserting their personal rights against third parties without compulsory assistance from the trustee.

Both the petitioner and the Securities and Exchange Commission assert in their briefs that there is a supposed need for preemptive suits brought representatively by Chapter X trustees because of practical difficulties barring debentureholders from effectively asserting their own rights. Taking this argument to its logical conclusion, the petitioner candidly admits that if the sweeping preemptive role he asserts in relation to all claims of any kind which he may discover on behalf of any investors or creditors becomes law, it would have the effect of finally dispensing with even the possibility of other class actions in every instance in which a reorganization trustee intervenes (Pet. Br. 21). The petitioner argues that he is better qualified and therefore should be the *only* suitor in behalf of investor groups, even though Rule 23 would have to be substantially reshaped to permit this.

But the capacity of debentureholders themselves is not so moribund as the petitioner suggests. In fact, their actions have proceeded in the present case; and in all likelihood they would have advanced much further toward resolution of the issues than has the petitioner, had not his preemptive suit stood in their way. They have been delayed by the threat implied in this action: that the expansion sought for the trustee's power to that of self-appointed volunteer class representative in all cases would undermine the mechanism of Rule 23 which is currently so widely utilized by private representatives of investor groups, depriving them of control over their own causes of action.

A. The pending debentureholders' actions which the petitioner would preempt are among the means by which Congress intended the "investor protection" measures of 1938-39 to be carried out.

When the Congress enacted the Chandler Act in 1938, it created the powerful position of trustee, whose occupant was given broad authority to protect investors by gathering the debtor's assets and representing them in the formulation of a reorganization plan. But at the same time, as has been shown, the legislators restricted this designee's responsibility—as the duties of an equity receiver traditionally had been circumscribed in this respect, as well—to the specific tasks set out in the Act. Investors or creditors who possessed claims which were no part of the debtor's estate were permitted to retain control of their own litigations based upon them and were never thought to have ceded them to a trustee who is not a member of the class at all.

This pattern of divided responsibility for litigation between the trustee and private investors or creditors was strengthened with the enactment of the Trust Indenture Act of 1939. The legislative history of Section 312 of that act, 15 U.S.C. § 77*lll*, which concerns bondholder lists, establishes that this measure was intended to provide each bondholder with easier access to the lists of all those similarly situated so that an individual suitor might initiate concerted action on behalf of bondholders as a group. The Senate Report on the Trust Indenture Act expressly states that Section 312 was intended to overcome "obstacles to concerted action by bondholders," noting:

> "Section 312 of the bill meets the problem of *restoring to the bondholders control of their own destinies* by providing that the indenture shall include a requirement that the issuing company fur-

> nish to the trustee at stated intervals or at the request of the trustees, information in its possession or control as to the names and addresses of the bondholders. It also contains provisions under which the trustee must either give the bondholders access to such lists or, without disclosing the list itself mail out on the request and at the expense of any bondholder, communication supplied by him relating to the rights of the bondholder."[12]

Thus Congress contemplated that the bondholders, now armed with a valuable weapon for concerted action, would be able to enforce their own rights by way of litigation.[13] The reorganization trustee was not needed to represent the bondholders' personal claims.[14]

The enactment of this provision in the Trust Indenture Act followed closely and built upon the promulgation in the previous year of the Federal Rules of Civil Procedure and the broadened class action remedy of Rule 23.

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[12] S. Rep. 248, 76th Cong., 1st Sess. (1939), 6 (emphasis added). *See* Statement of Commissioner Eicher, Securities and Exchange Commission, Hearings Before a Subcommittee of the Committee on Banking and Currency, United States Senate, 76th Cong., 1st Sess. on S. 477, February 7, 1939, p. 30.

[13] Among the primary reasons for the passage of the Trust Indenture Act was the desire

> ". . . to provide machinery whereby . . . continuing disclosure may be made to the security holders, *and whereby they may get together for the protection of their own interests.*" (Emphasis added.)

2 Loss, *Securities Regulation* 725 (2d ed. 1961).

[14] The quotation contained in petitioner's brief (Pet. Br. 19) from Section 302(a)(1) of the Trust Indenture Act, 15 U.S.C. § 77bbb (a)(1), is taken from what is in effect the preamble of the Act, describing the *former* situation requiring regulation. Section 312 was enacted as a step toward facilitating action by bondholder groups and is inconsistent with any congressional intention to eliminate them in favor of a preemptive trustee.

Originally an invention of equity, the class action was extended by the adoption of the Federal Rules to the entire field of federal civil litigation. *See Hansberry* v. *Lee*, 311 U.S. 32, 41 (1940); *United Mine Workers of America* v. *Coronado Coal Co.*, 259 U.S. 344, 387-89 (1922); 3B Moore, *Federal Practice, supra*, ¶ 23.02[1]; 2 Barron & Holtzoff *Federal Practice and Procedure, supra* § 561. In recent years, it has been favored by many litigants asserting claims which are personal to investors or creditors. *E.g., Green* v. *Wolf Corp.*, 406 F.2d 291 (2d Cir.), *cert denied*, 395 U.S. 977 (1969); *Eisen* v. *Carlisle & Jacquelin*, 391 F.2d 555 (2d Cir. 1968); *Escott* v. *BarChris Construction Corp.*, 340 F.2d 731 (2d Cir.), *cert. denied*, 382 U.S. 816 (1965). As one court has put it,

> "The resolution in one litigation of the common questions relating to the existence, character, and materiality of the alleged [securities law violations] avoids the need for each injured investor to attempt to prove—and for the defendants to disprove—anew these basic allegations. Thus, it is virtually certain that a class action will 'achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated.' Advisory Committee Notes to Rule 23, 39 F.R.D. at 102-103." *Dolgow* v. *Anderson*, 43 F.R.D. 472, 488 (E.D. N.Y. 1968), *rev'd on other grounds*, 438 F.2d 825 (2d Cir. 1971).

In the present case, one group of litigants suing in federal court in New York invokes Rule 23 to assert claims on behalf of individuals, a "Debenture Protective Committee," and a class composed of all purchasers, holders and sellers of Webb & Knapp debentures. *Lewis* v.

Marine Midland Grace Trust Company of New York, 68 Civ. 1764 (S.D.N.Y. 1968). The present amended and supplemental complaint in that action (A-12) recites the same factual allegations made by petitioner and charges that Marine Midland and others engaged in conduct violating the Securities Act of 1933, the Securities Exchange Act of 1934, and common law negligence principles.[15]

Discovery has been sought in the *Lewis* case but has been stayed by the district court as a direct result of the continuation of the present action.

It is therefore disingenuous for the petitioner to suggest that his pursuit of the common claims is "vigorous" and the debentureholders' efforts ineffective, since his own lengthy litigation over the question of his standing has been the major reason for delay in the private action he would summarily dismiss.

Another action, in a state court of New York, also has been brought on behalf of a class or classes of debentureholders. This suit is brought on behalf of the individual plaintiff and "all other present and former holders" of the debentures, and it presents all the claims made in the present case and more. The New York County Supreme Court has ruled that this suit may proceed as a class action, stating that *Elkind* v. *Chase National Bank*, 259 A.D. 661 (1st Dept. 1940), *aff'd* 284 N.Y. 726 (1941), which is cited by petitioner (Pet. Br. 19), is no longer the law in New

[15] In November of 1971, following the Second Circuit's decision herein and prompted, presumably, by footnote 5 in Judge Friendly's opinion (App. 92a), plaintiffs moved for permission to amend their complaint to include claims based on the Trust Indenture Act. That motion had been stayed pending the outcome of the petitioner's appeal to this Court.

York: *Ray* v. *Marine Midland Grace Trust Company*, N.Y.L.J., January 12, 1971, p. 19, col. 1 (Sup. Ct. N.Y. Co.). The decision is presently on appeal, and some discovery has been had.

The petitioner thus would at present preempt *two* ongoing suits by representatives of the debentureholders whom he characterizes as unlikely to be able to act "effectively" without his intervention. His plea for an expansion of his statutory powers thus is a direct attempt to seize control of the debenture holders' own law suits.[16]

B. Intervention by the trustee in the area of private litigation would hamper performance of his statutory duties and undermine the carefully developed scheme of investors' remedies under Rule 23 and otherwise.

The petitioner's claim in this case is closely analogous to that advanced by the petitioner in *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, in which a State claimed to act in the role of *parens patriae* or, as the Court put it, "the general guardian of all infants, idiots and lunatics,"[17] in pursuing an antitrust action on behalf of its citizens.

In its *State of Hawaii* opinion, the Court pointed to the problems of possibly overlapping classes and double recovery inherent in any litigation by a State as representative of the economic interests of individual citizens; and the

---

[16] Petitioner's brief also expresses a patronizing attitude toward members of the securities bar located outside "the great financial centers," whom the petitioner assumes to be "unsophisticated" and not "aggressive" in serving private investors (Pet. Br. 19).

[17] *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, 4248, quoting 3 W. Blackstone, *Conversations* 47-8 (E. Christian, ed. 1794).

Court insisted upon a clear expression of congressional purpose to authorize such a departure. The Court observed that "private citizens are not as powerless as the State suggests," and it pointed to the "definitely preferable" mechanism of Rule 23, with its specific rules for delineating workable boundaries in the area of class suits. *Id.*, at 4250-51.

The petitioner in the present action likewise would reach beyond his own authorized area of responsibility for the protection of trust property and bring a claim on behalf of private individuals—in this case in the face of legislation plainly expressing a contrary congressional purpose. He similarly would brush aside difficulties in defining the ultimate scope of his claim of authority to represent any and all investors and ignore problems of double recovery,[18] as well as the presence of Rule 23, by characterizing the debentureholders as akin to "infants, idiots and lunatics" in need of a general guardian. In addition, the petitioner asserts a claim to represent a class of individual debenture-

[18] Double recovery problems could be raised if the petitioner is authorized to pursue negligence claims on behalf of all present debentureholders, while members of this group themselves maintain class actions under the securities laws on behalf of all purchasers or sellers of the debentures during various years. In addition, the possibility of expanding any action on behalf of the debentureholders to name all defendants implicated in culpable conduct could place the petitioner trustee in a position of conflicting interest. The bulk of the defendants in the *Lewis* action are former officers and directors of Webb & Knapp, the persons who authored and submitted the valuation certificates which it is alleged that Marine Midland "ought to have known" were inaccurate. Yet the petitioner has already entered into settlements with certain key individual defendants on behalf of the estate, in the process adopting positions and making representations to the reorganization court which might raise serious problems of litigation tactics should he now attempt to sue the same persons on the basis of very closely related facts on behalf of the debentureholders. Were the actions kept separate as intended under all the applicable statutes and rules, no such difficulties would arise.

holders in pursuit of their personal claims in spite of a comparable unanimity of lower court opinions opposing such a notion.

As in the *State of Hawaii* action, the petitioner herein both mistakes the nature of the statute he invokes and belittles the availability of class actions under Rule 23, which the Court has said may "enhance the efficacy of private actions by permitting citizens to combine their limited resources to achieve a more powerful litigation." *Id.*, at 4250.

In summary, the trustee's present attempt to preempt any individual class action, if successful, would have the dual effect of both decreasing his effectiveness in his proper role as guardian of the debtor's property and at the same time undermining private litigants' incentive to bring a wide variety of such suits in the future. On the one hand, a trustee might be tempted to delay the consummation of a plan of reorganization to the detriment of some investors while pursuing the personal claims of others through years of litigation; and he might face conflicts between positions taken in litigation on behalf of the estate and related claims belonging to others. And on the other hand, if a Chapter X trustee's mandate extends to the preemption of *all* claims by investors or creditors of any company which later passes into reorganization, a cloud would hang over any class suit commenced under Rule 23 involving a corporation in financial distress. Unless such actions were already far advanced by the time of his appearance, the trustee might argue, in the words of petitioner herein, that he has superior access to the debtor's files and therefore is *the* appropriate class representative.

The petitioner's appeal is based ultimately on the implications he finds in legislative history of 35 years ago, which constituted timely commentary upon problems of that day. The situation has been altered drastically by a third of a century of practice under the new investor-oriented laws which were the products of that era and by the parallel explosion of private class action litigation. Petitioner's sketchy presentation suggests no evidence which would be likely to cause a legislative body to believe without further investigation of current practices that the former problems remain unaltered and require radical surgery upon Chapter X of the Bankruptcy Act. It affords even less justification for the proposed judicial reshaping of the long-established relationship between the Chapter X trustee's duties and the role of private litigants.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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SULLIVAN & CROMWELL,
JAMES H. CARTER,
Of Counsel.

MARCH 1972.

APPENDIX

Statutes Involved

The Bankruptcy Act, 11 U.S.C. §§ 1, *et seq.*, provides in pertinent part:

Section 47 (11 U.S.C. § 75):

> Duties of Trustees. (a) Trustees shall (1) collect and reduce to money the property of the estates for which they are trustees . . .
>
> . . . .

Section 70 (11 U.S.C. § 110):

> Title to Property. (a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this Act . . . to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor . . . (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests

in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this Act, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

* * *

Section 167 (11 U.S.C. § 567):

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

* * *

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desira-

bility of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

(6) shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named.

* * * *

Section 186 (11 U.S.C. § 586):

A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.

Section 187 (11 U.S.C. § 587):

Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

Section 312 of the Trust Indenture Act of 1939, 15 U.S.C. § 77*lll*, provides in pertinent part:

(a) The indenture to be qualified shall contain provisions requiring each obligor upon the indenture securities to furnish or cause to be furnished to the

institutional trustee thereunder at stated intervals of not more than six months, and at such other times as such trustee may request in writing, all information in the possession or control of such obligor, or of any of its paying agents, as to the names and addresses of the indenture security holders, and requiring such trustee to preserve, in as current a form as is reasonably practicable, all such information so furnished to it or received by it in the capacity of paying agent.

(b) The indenture to be qualified shall also contain provisions requiring that, within five business days after the receipt by the institutional trustee of a written application by any three or more indenture security holders stating that the applicants desire to communicate with other indenture security holders with respect to their rights under such indenture or under the indenture securities, and accompanied by a copy of the form of proxy or other communication which such applicants propose to transmit, and by reasonable proof that each such applicant has owned an indenture security for a period of at least six months preceding the date of such application, such institutional trustee shall, at its election, either—

(1) afford to such applicants access to all information so furnished to or received by such trustee; or

(2) inform such applicants as to the approximate number of indenture security holders according to the most recent information so furnished to or received by such trustee, and as to the approximate cost of mailing to such indenture security holders the form of proxy or other communication, if any, specified in such application.

If such trustee shall elect not to afford to such applicants access to such information, such trustee shall, upon the written request of such applicants, mail to all such indenture security holders copies of the form of proxy or other communication which is specified in such request, with reasonable promptness after a tender to such trustee of the material to be mailed and of payment, or provision for the payment, of the reasonable expenses of such mailing, unless within five days after such tender, such trustee shall mail to such applicants, and file with the Commission together with a copy of the material to be mailed, a written statement to the effect that, in the opinion of such trustee, such mailing would be contrary to the best interests of the indenture security holders or would be in violation of applicable law. Such written statement shall specify the basis of such opinion. After opportunity for hearing upon the objections specified in the written statement so filed, the Commission may, and if demanded by such trustee or by such applicants shall, enter an order either sustaining one or more of such objections or refusing to sustain any of them. If the Commission shall enter an order refusing to sustain any of such objections, or if, after the entry of an order sustaining one or more of such objections, the Commission shall find, after notice and opportunity for hearing, that all objections so sustained have been met, and shall enter an order so declaring, such trustee shall mail copies of such material to all such indenture security holders with reasonable promptness after the entry of such order and the renewal of such tender.

* * *

Complaint

SUPREME COURT OF THE STATE OF NEW YORK

COUNTY OF NEW YORK

DAVID RAY, on behalf of himself and all other present and former holders of the 5% Sinking Fund Debentures of Webb & Knapp Inc., due June 1, 1974,

Plaintiff,

—against—

MARINE MIDLAND GRACE TRUST COMPANY,

Defendant.

Plaintiff above named, for his complaint, respectfully alleges upon information and belief, except as to the allegations contained in paragraphs "1" and "23" which are alleged upon knowledge:

* * *

7. The 5% Debentures were not secured by any lien, but under the Indenture the said debentures were entitled to the benefit of certain restrictive covenants which, among others, included the following:

* * *

(b) Under Section 3.6 of the Indenture, W&K agreed that neither it nor its consolidated subsidiaries would incur or assume any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property on which W&K or any of its said subsidiaries

were personally liable, nor would they purchase any real property or interests in real property, unless in either case, on a date not later than four months prior to the date of the transaction, but after giving effect to the transaction, consolidated tangible assets of W&K and its subsidiaries, as defined in the Indenture, equalled 200% of consolidated liabilities as therein defined.

(c) Under Section 3.11 of the Indenture, W&K agreed that within 120 days after the close of its fiscal year ending December 31, 1954, and within 120 days after the close of each fiscal year thereafter, W&K would file with the Indenture Trustee, an officers' certificate, stating that in the course of the performance of their duties as officers of the Company they would normally obtain knowledge of any default by W&K in the performance or fulfillment of any covenant, agreement or condition contained in the Indenture, and stating whether or not they have obtained knowledge of any such default, and, if so, specifying each such default of which they have knowledge and the nature thereof.

• • •

15. (a) Notwithstanding that compliance with Section 3.6 of the Indenture required that W&K maintain a two-to-one ratio with respect to its consolidated tangible assets and consolidated liabilities, as aforesaid, based on computations made not later than the four months period preceding a transaction involving the borrowing of money or the purchase of real property, Marine Midland, in the years subsequent to the issuance of the 5% Debentures through the year 1962, requested W&K to submit to it only once in

each year an appraisal of the assets of W&K for the purpose of determining whether W&K was in violation of the provisions of Section 3.6 of the Indenture.

(b) The said yearly appraisals delivered to Marine Midland, at least for the years 1961 through 1964, grossly overstated the assets of W&K and, as known to Marine Midland, said appraisals were based primarily on self-serving and unrealistic valuations which were not based on cost or market, but instead, upon the views of officers of W&K, who were not independent appraisers, as to what the properties could be sold for on a cash basis under favorable market conditions after their earning power shall have been clearly established.

(c) Marine Midland, as Indenture Trustee, knew, or should have known, that said appraisals were false and were not prepared in accordance with accepted standards of valuation of real estate and that at least during the period from 1961 until May 1965, W&K was not maintaining consolidated tangible assets equal to 200% of liabilities as required by Section 3.6 of the Indenture. During said period, the said ratio was substantially less than two-to-one.

(d) Marine Midland knew, or should have known, that by reason of W&K's inability to maintain the said two-to-one ratio at least during the period from 1961 until May 1965, the real estate borrowings and purchases of real estate by W&K and its consolidated subsidiaries constituted violations of Section 3.6 of the Indenture.

(e) Marine Midland wilfully and with gross negligence failed to prevent the said violations of Section 3.6 of the

Indenture and permitted W&K and its consolidated subsidiaries during said period to engage in a large number of transactions for the purchase of real estate or interests in real estate and to incur huge amounts of additional short-term indebtedness, which resulted in substantial losses and diminution of the assets of W&K and its eventual insolvency; all to the detriment, damage and injury of the 5% Debenture holders.

* * *

16. In further breach of its duties under the Indenture, Marine Midland knew, and was so informed by W&K, that events of default under the Indenture had occurred during the year 1963 in that the maturity of certain indebtedness of W&K in excess of $6,235,000 had been declared accelerated and due and payable by reason of the occurrence of events of default as defined in mortgages, indentures (other than the Indenture), or other instruments. As known to Marine Midland, W&K was unable to have said accelerations rescinded or annulled. Notwithstanding said knowledge, Marine Midland did not give written notice to W&K until on or about June 25, 1964, requiring W&K to effect the said rescission or annulment. Although the grace period under the Indenture (more particularly Section 6.1 thereof) expired on July 6, 1964, Marine Midland then failed to accelerate maturity of the principal of the 5% Debentures for almost one year thereafter, despite its knowledge that said default had not been cured, that W&K was unable to meet its debts as they matured, that W&K was in financial distress, and that W&K was causing its remaining unencumbered property to be pledged with other creditors; all

to the detriment, damage and injury of the 5% Debenture holders.

* * *

20. (a) At pertinent times herein, Marine Midland suffered from a conflict of interest between its banking business affairs and its position as Trustee under the Indenture, and by reason thereof it failed to take necessary steps to protect the interests of the 5% Debenture holders, as aforesaid.

* * *

22. By reason of all the foregoing, Marine Midland violated the duties owed by it as Indenture Trustee to the plaintiff and to every other member of the class herein, and it thereby caused damage, injury and loss to the present and former holders of 5% Debentures who constitute the class as aforesaid. Marine Midland is liable for the loss and damage suffered by each member of the class.

23. The members of the class are so numerous as to make it impracticable to join them all in this action. There are questions of law and fact common to the class. The plaintiff will fairly and adequately protect the interests of the class.

WHEREFORE, plaintiff demands judgment against the defendant, as follows:

(1) That the plaintiff and each other member of the class recover from the defendant herein damages for the wrongs herein complained of;

(2) That this Court grant to the plaintiff and the other members of the class such other and further relief as may be just and proper in the premises; and

(3) That this Court award to the plaintiff the costs and disbursements of this action, including reasonable fees to plaintiff's counsel and accounting and other experts.

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Amended and Supplemental Complaint

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

68 Civ. 1764

HARRY LEWIS, Suing both individually and as Chairman of the Webb & Knapp, Inc. 5% Sinking Fund Debenture Protective Committee, an Unincorporated Association, on behalf of all purchasers of 5% Sinking Fund Debentures due 1974, issued by Webb & Knapp, Inc. similarly situated, and ABRAHAM A. TUROFF,

Plaintiffs,

—against—

MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK, HARRIS, KERR, FORSTER & CO., WILLIAM ZECKENDORF, B. A. TOMPKINS, ARTEMUS L. GATES, MAURICE ISERMAN, ARTHUR J. PHELAN, ARTHUR G. RYDSTROM, NICOLAS M. SALGO, ELLIOT H. BINZEN, HERBERT I. SILVERSON, RUDOLF SMUTNY, JAMES A. VAN FLEET, ARNOLD M. GRANT, WILLIAM ZECKENDORF, JR., EDWARD Y. BAUGEARD, JARED C. HORTON, ARTHUR T. ROTH, DAVID W. WALLACE, WILLIAM C. WARREN, JOSEPH P. BOHAN, HENRY R. BOSTON, O. HENRY BRIGGS, RONALD A. NICHOLSON, ROBERT B. ANDERSON, LEWIS W. DOUGLAS, THOMAS P. JEBMAN, KENNETH A. KEITH, GRAYSON M. P. MURPHY, STUART F. SILLOWAY, HARRY V. LETT,

Defendants.

PLAINTIFFS DEMAND A TRIAL BY JURY

Plaintiffs for their amended and supplemental complaint ("complaint"), by Wolf Popper Ross Wolf & Jones, their

attorneys, allege upon information and belief, except as to paragraphs "1(a)" through "1(c)" which are alleged on knowledge:

• • •

COUNT ONE

1. (a) Plaintiff Harry Lewis purchased Webb & Knapp, Inc., ("the Company"), 5% Sinking Fund Debentures ("debentures") on November 15, 1963 and still retains them.

(b) Plaintiff Abraham A. Turoff purchased debentures in 1956 and sold them on October 19, 1966 at a loss.

(c) Plaintiff Webb and Knapp, Inc. 5% Sinking Fund Debenture Protective Committee ("Committee") was formed on June 7, 1967 to protect the interests of debenture holders. The members of the Committee are: Harry Lewis, Chairman; Louis Kipnis, Secretary; and Stephen Abrams. The Committee presently represents 152 debenture holders owning debentures with a face amount of approximately $275,000. These debenture holders purchased their debentures on various dates between 1954 and 1965.

2. Plaintiff Committee brings this Count on behalf of all debenture holders it represents.

3. All plaintiffs bring this Count upon their own behalf, those whom they represent and all other purchasers of debentures similarly situated.

4. Said purchasers of the debentures constitute a class so numerous as to make it impractical to bring them all before the Court. Plaintiffs will fairly ensure adequate

representation of the interests of the entire class of persons on whose behalf this Count is brought.

5. Questions of law and fact common to all members of said class are involved herein.

6. The Trust Indenture which is the subject of this action, and the bonds issued thereunder, were issued pursuant to a prospectus and registration statement filed with the Securities and Exchange Commission pursuant to the provisions of the Securities Exchange Act of 1933 ("Securities Act") and the Trust Indenture Act of 1939 ("Trust Act"). Under the definitions described in Section 1.2 of the Indenture, the terms used therein have the meaning assigned to them in the Trust Act and Securities Act. The Trust Indenture is governed by all the Rules and Regulations of the Securities and Exchange Commission dealing with securities and trust indentures.

7. The acts complained of herein constitute violations of Section 10(b) of the Securities Exchange Act of 1934, as amended (15 U.S.C. § 78p(b), ("Exchange Act"), Rule 10b-5 promulgated thereunder (17 CFR 240.10b-5) and the common law. This Court has jurisdiction pursuant to Section 27 of the Exchange Act, (15 U.S.C. 78aa) and the doctrine of pendent jurisdiction.

* * *

9. From 1954 through 1964, the defendants employed devices, schemes and artifices to defraud, and engaged and continued during such period to engage in acts, practices and a course of conduct which was intended to and did operate as a fraud upon plaintiff and all other purchasers similarly situated, through the use of the mails and other means

and instrumentalities of interstate commerce in connection with the purchase and sale of the securities and bonds of the Company covered by the Trust Indenture herein.

• • •

17. Under the terms of Section 3.6(a) of the Trust Indenture, the Company was barred from incurring or assuming any indebtedness resulting from money borrowed or from the purchase of real property or interest in real property unless its consolidated tangible assets were equal to 200% of the liabilities of the Company, as such provisions are specified in said Section.

• • • •

20. Pursuant to a plan or scheme and continuous course of conduct of the directors-officers of the Company, and with the knowledge and approval of Marine Midland and Harris, Kerr, the Company filed with the Indenture Trustee Marine Midland, false, fraudulent, reckless and exaggerated statements of the values of the real estate and other assets; such valuations which the directors-officers made or approved during the times when they served as such directors-officers were grossly, fraudulently and recklessly inflated by the directors-officers in order to meet the requirements of the Indenture regarding the restrictions on real estate and other transactions as required by Section 3.6 of the Indenture.

21. The directors-officers by their actions in making false, grossly exaggerated and reckless statements, and Marine Midland and Harris, Kerr by approving these actions, dis-

regarded the fiduciary duties which they owed to the debenture purchasers as well as violating their duties and obligations under the Securities Act, Section 10b of the Exchange Act and its implementing Rule 10b-5.

* * *

23. Marine Midland aided and abetted the fraudulent scheme of the directors-officers set forth in paragraph "20" above by:

(a) Accepting asset valuations given to it by the Company between the years 1955 and 1965 without independent investigation and verification of the valuations, and was grossly negligent and reckless in failing to ascertain the pertinent facts;

(b) these valuations were grossly inflated by the directors-officers in order to meet the requirements of the Indenture regarding the restrictions on real estate transactions unless the Company's assets were twice the liabilities.

(c) Marine Midland knew or, in the exercise of prudent care, should have known that the valuations were false and grossly inflated by the directors-officers.

24. Marine Midland was grossly negligent and reckless in performing its duties and responsibilities as Trustee and aided and abetted the fraud of the directors-officers in failing to disclose and concealing from plaintiffs and all other purchasers of the debentures that the Company was in default under the terms of the Indenture because the valuations were grossly inflated as a result of which the Company failed to comply with the requirements of the Inden-

ture and in not calling the entire issue in default by reason of this.

• • •

26. Plaintiffs and all other purchasers of the indentures relied upon the fraudulent activities of the directors-officers and the actions of Marine Midland and Harris, Kerr in aiding and abetting this fraud when they purchased their debentures. At the time of the purchases, plaintiffs and all other purchasers similarly situated relied upon the fact that the Company was complying in all respects with the Indenture and was not in default, when in truth and in fact this was not so, since the fraud of the defendants concealed the true facts, that the Company was not in compliance. Furthermore, the fraud as herein alleged had the effect of artificially inflating the market price of the debentures.

27. Had plaintiffs and all other members of the class known the true state of affairs of the Company, its failure to comply with the Indenture and its defaults at the time they purchased their debentures they would not have made the purchases.

28. By reason of the foregoing, plaintiffs and all other purchasers of the debentures similarly situated have been substantially damaged, the exact amount of which is ascertainable only upon a full and complete accounting herein.

29. By reason of the acts and conduct complained of, plaintiffs and all other members of the class are also entitled to exemplary and punitive damages.

COUNT TWO

Against Marine Midland Grace Trust Company of New York

30. This count is brought on behalf of all persons who were the owners of the Company's debentures on any date during the period July 1, 1964 to July 31, 1964.

31. Plaintiffs repeat and reallege paragraphs "1", "2", "5", "6", "8", "11", "12" and "16" of this complaint.

32. Jurisdiction is based on the doctrine of pendent jurisdiction.

33. Said debentureholders constitute a class so numerous as to make it impractical to bring them all before the Court. Plaintiffs will fairly ensure adequate representation of the interests of the entire class.

34. On or about June 1, 1964 the Company defaulted on a $431,000 sinking fund payment and a $120,000 interest payment on said debentures. The Indenture provides for a thirty-day grace period as to interest payments. The Company made the interest payment on June 30, 1964 at 8:00 P.M., four hours before the end of the grace period.

35. Marine Midland, in violation of its duties as Trustee, and in complete disregard of the poor financial condition of the Company, which was not meeting its obligations, extended the Company's time to make the sinking fund payment to July 31, 1964, rather than calling the entire issue immediately due upon the effective date of the default. The

sinking fund payment was made on July 31, 1964, the last day of the extension.

36. Marine Midland was grossly negligent and reckless in not calling the entire issue due at the time of the default in light of the financial condition of the Company on that date, which Marine Midland knew, or in the exercise of prudent care, should have known.

• • •

38. Plaintiffs and all other bondholders similarly situated were substantially damaged by the grossly negligent and reckless conduct of Marine Midland.

39. Plaintiffs repeat and reallege paragraph "29".

WHEREFORE, the plaintiffs demand judgment:

ON COUNT ONE

That defendants pay to plaintiffs and all other members of the class the damages which they have sustained from defendants' wrongs together with interest and punitive damages;

ON COUNT TWO

That defendant Marine Midland pay to plaintiffs and all other members of the class the damages which they have sustained from its wrongs together with interest and punitive damages;

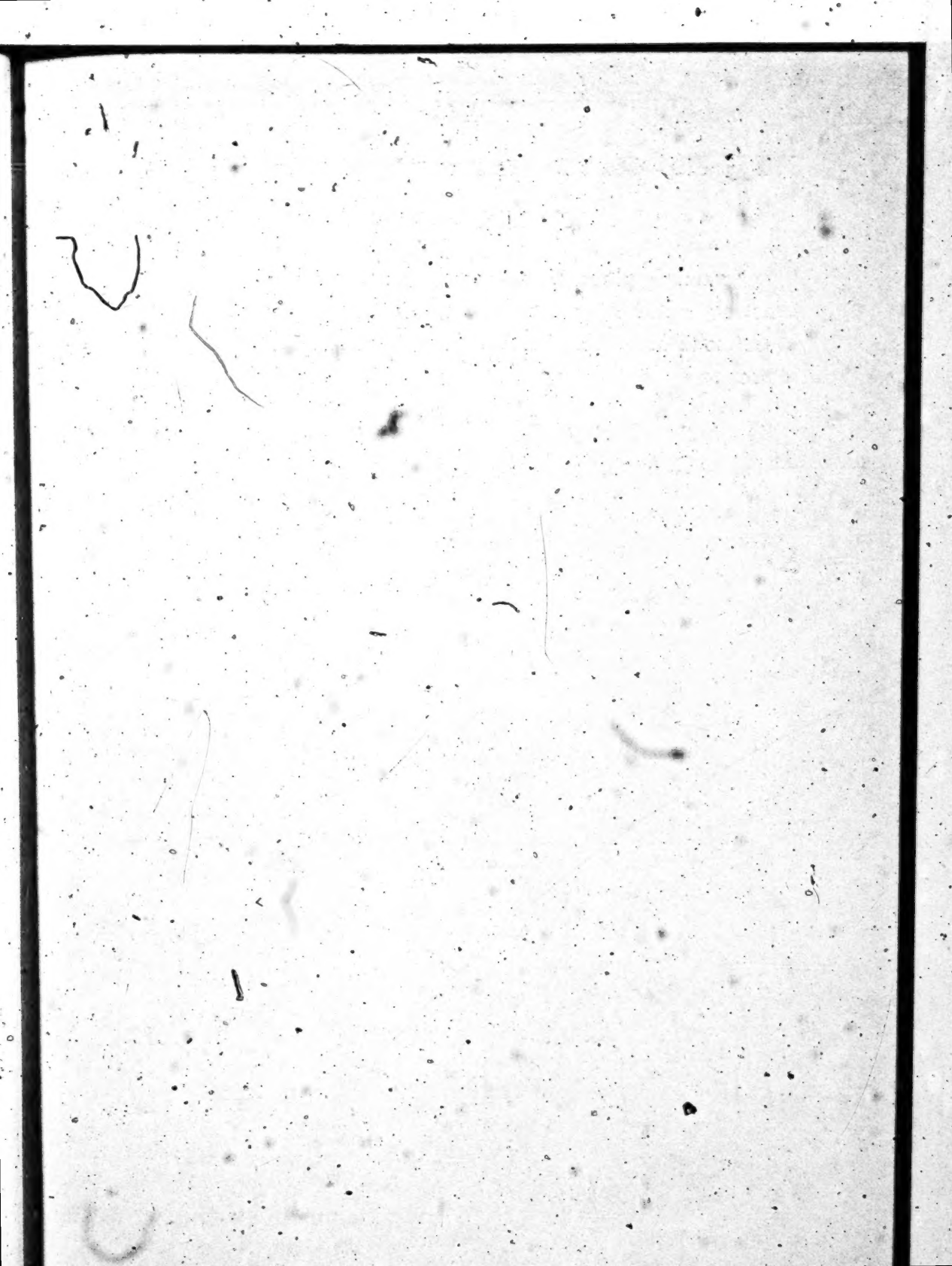
ON BOTH COUNTS

Awarding plaintiffs the costs and disbursements of this action including reasonable counsel and accounting fees and such other and further relief as the Court may deem proper.

Dated: New York, N. Y.
December , 1969

WOLF POPPER ROSS WOLF & JONES

By: .....
A Member of the Firm
Attorneys for Plaintiffs
845 Third Avenue
New York, New York 10022
PL. 9-4600



In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, TRUSTEE IN REORGANIZATION OF WEBB & KNAPP, INC., ETC., PETITIONER

v.

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

1. Respondent Marine Midland incorrectly states that "no claim is made by the Chapter X trustee that Marine Midland's alleged failure to ascertain or prevent Webb & Knapp's breach of covenant caused or contributed to the insolvency or bankruptcy of Webb & Knapp * * *" (Br. 6). The Chapter X trustee charged in identical language both in his complaint in the plenary action and in his counterclaim to Marine Midland's proof of claim in the reorganization proceeding (App. 47a-48a; 52a-53a):

461-163—72

> The failure of Marine to take appropriate steps to prevent the borrowing of funds or the purchases of property by the Debtor enabled the Debtor to enter into countless transactions in violation of the covenant contained in Section 3.6 of the Indenture with resultant loss and diminution of assets of the Debtor which caused the net worth of the Debtor to be reduced from $25,066,657 as of December 31, 1958 to a deficit of $38,500,000 at the time of the filing of the petition in these proceedings.

Had Marine, in accordance with the indenture under which it accepted fiduciary obligations, prevented further borrowings and purchases of property by the debtor as soon as the debtor's liabilities exceeded half the value of its assets, the debtor presumably would not have fallen into its present financial difficulties. This situation thus is fundamentally the same as that in *McCandless* v. *Furlaud,* 296 U.S. 140, 158, where this Court pointed out that the effect of the defendants' conduct "was to saddle the company with liens beyond the value of its assets mortgaged and unmortgaged." Just as a receiver was there permitted to bring an action for recovery of the damages suffered by the bondholders and noteholders of the debtor company, the Chapter X trustee here should be permitted to seek recovery for the damages suffered by the debenture holders of Webb & Knapp.

2. Marine's brief concedes that a moderate extension of a Chapter X trustee's litigation authority might be appropriate, but argues that it "is impossible to glean" from petitioner's brief any definition of what petitioner considers to be "the *proper* limits to be placed upon a trustee's powers to assert claims"

on behalf of a group of investors, stating that petitioner "seems to envisage no limits" (Br. 21, emphasis in original). The "limits" in the present case are determined both in terms of the persons the trustee seeks standing to represent and the amount he claims for them. That is, he would represent in the lawsuit only the present holders of the debtor's debentures—persons who are, in any event, necessarily before the bankruptcy court as creditors of the debtor and whose claims are subject to adjustments in the reorganization plan. The amount sought in the lawsuit could not exceed the principal outstanding balance due on the debentures (with interest on that amount and costs).[1] These limits may be contrasted with (1) the judgment demanded in the complaint in the state court action (see appendix to Marine Br., pp. A–6 to A–11), where damages for all present and former holders of the debentures are sought, together with any other appropriate relief, and (2) the demand for judgment in the federal court suit (see appendix to Marine Br., pp. A–12 to A–20), which would recover actual and punitive damages for, among others, persons who purchased debentures and subsequently sold them at a loss.

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[1] See the dissenting opinion of Judge Learned Hand in *Clarke* v. *Chase National Bank*, 137 F. 2d 797, 802 (C.A. 2):

"What difference can it make that the beneficiaries of the covenants here in question were only a part of those—the creditors at large—who were aggrieved by the debtor's conduct? The others had not provided themselves with a guardian over their interests, and have no one whom they can call to account. Although the measure of the guardian's liability is that of his wards' losses, what bearing has it that there were others who have no claim to restoration? * * *"

In terms of "limits," the trustee's lawsuit in this case is not essentially different from actions in other cases cited in our initial brief where recoveries were obtained by Chapter X trustees against indenture trustees for bondholders or debenture holders, with the proceeds of such recoveries going to those security holders and not to the estate generally.[1] The trustee here, in effect, seeks to have restored to the debenture holders so much of the debtor's estate as allegedly would have been available to pay the balance due on the debentures had it not been for Marine's misconduct.

3. Pervading Marine's brief is a response to an argument which neither petitioner nor the Commission has made. Only Marine has contended that the Chapter X trustee's suit on behalf of the debenture holders would "sweep the field clean of other proceedings" by preempting other suits by investors (Br. 9; and see Br. 20, 21, 22, 39 and 40). Neither the Commission nor petitioner has argued that the Chapter X trustee should be deemed to be authorized by the Bankruptcy Act to serve as "the exclusive enforcer of *all* claims of investors against third parties * * * " (Br. 22, emphasis in original); nor have we argued, as Marine contends (Br. 39), that there is a need for preemptive suits brought by Chapter X trustees in their representative capacities.

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[1] See *In re Solar Manufacturing Corp.*, 200 F. 2d 327 (C.A. 5), certiorari denied *sub nom., Marine Midland Trust Co. v. McGirl*, 345 U.S. 940, and *Clarke v. Chase National Bank*, *supra*, 187 F. 2d at 801; cf. *Prudence-Bonds Corps. v. State Street Trust Co.*, 202 F. 2d 555 (C.A. 2), certiorari denied, 346 U.S. 835.

While, for reasons stated in the petitioner's and the Commission's briefs, a Chapter X trustee would normally be in a better position to provide debenture holders with more vigorous and effective representation than they might receive in a class action, it is possible that a court might determine in particular circumstances that a pending class action would afford greater protection to the rights of investors involved. The question is not one of preemption, as Marine suggests; it is simply a question of the standing of the trustee to bring the action.

For the foregoing reasons and for the reasons stated in our main brief, it is respectfully submitted that the judgment of the court of appeals should be reversed.

Respectfully submitted.

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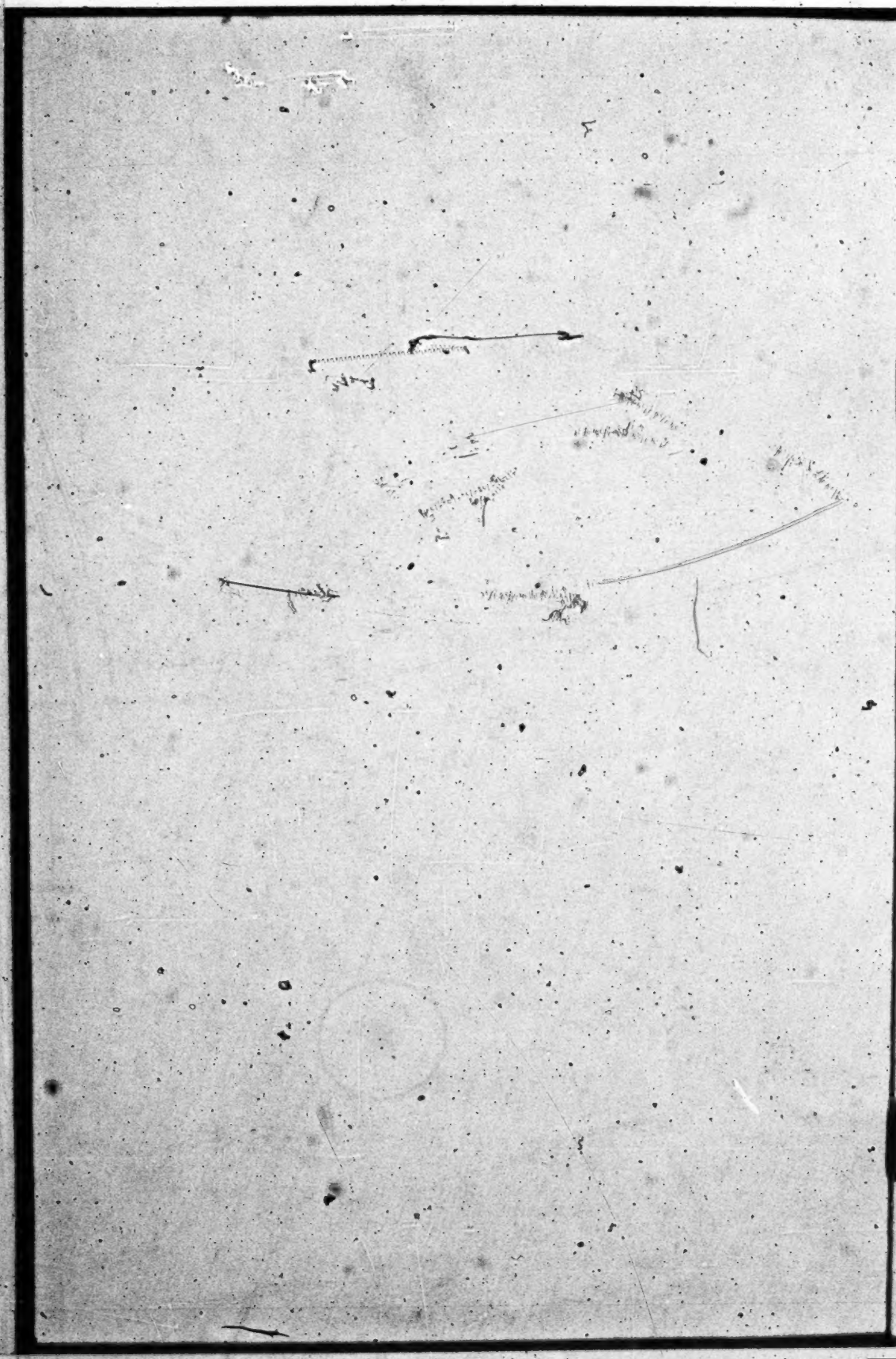

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-220

MORTIMER M. CAPLIN, Trustee in Reorganization of Webb & Knapp, Inc., etc.,

Petitioner,

against

THE MARINE MIDLAND GRACE TRUST COMPANY OF NEW YORK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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LEON E. IRISH

IN THE

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REPLY BRIEF FOR THE PETITIONER

In challenging the Trustee's standing to prosecute an action on behalf of debenture holders against Marine, Marine asks this Court to reject positions never taken by the Trustee and arguments never made by him. Contenting itself to setting up, and then knocking down, these strawman contentions, Marine only rarely even attempts to meet those arguments which *were* made by the Trustee. Furthermore, in the final analysis Marine would have this Court

impose a standing requirement even more restrictive than that adopted by the Court below.

POINT I.

A Chapter X Trustee is the appropriate party to commence an action on behalf of debenture holders against an Indenture Trustee when, as here, the subject matter of the action is significantly related to the debtor's affairs.

1. Far from formulating an "*ad hoc* rule of no rule at all" (Resp. Br. 23), the standing rule sought by the Trustee takes into account the practical realities of the corporate reorganization process. Marine attempts to portray the Chapter X trustee as a ministerial officer who goes about collecting the various properties of the estate and distributing them in accord with a fixed schedule of priorities, as though using a check list. This view of the trustee, possibly accurate to a point in the context of *straight bankruptcy*, is totally at odds with the concept of the trustee as the 'focal point' for reorganization envisioned by the framers of Chapter X.*

The reorganization trustee is not merely, or even primarily, a supervisor of the liquidation of corporate assets. On the contrary, he is charged with the complicated task of taking a financially-crippled corporation and, through the deft use of business management, corporate finance and legal processes, rehabilitating the corporation and salvaging a financial interest for various classes of its creditors as well as its stockholders and other investors. See, e.g., *SEC* v. *American Trailer Rentals Co.*, 379 U.S. 594, 603-604 (1965).

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* H. Rep. 1409, 75th Cong., 1st Sess. (1937), 43-44. (Pet. Br. 10-11).

It is this reorganization process* which is at the very heart of Chapter X, and not, as Marine would have this Court believe, an apparently semi-automated search for property, on a statutory subsection-by-subsection check list basis (Resp. Br. 13-15).

The "practical dynamics of bankruptcy reorganization," which Marine belittles (Resp. Br. 25), are vividly portrayed in the two recent proceedings in the Eastern District of New York, ignored entirely by Marine, in which reorganization trustees negotiated settlements with indenture trustees in circumstances comparable to those involved here.**

2. In line with these practical dynamics of reorganization, the formulation of the standing rule which the Trustee suggests is that the subject matter of the action have a *significant relationship* to the debtor's affairs. In determining whether such a significant relationship exists, several factors would come into play. These would include whether the subject matter of the action was one which the trustee was required in the normal course of his duties to investigate and report upon under Section 167(3) of the Bankruptcy Act; whether the alleged activities of the defendant contributed to the debtor's underlying financial problems; the possible impact of the action upon the formulation or acceptance of a plan of reorganization; the amount of the claim; and the number of investors and creditors of the debtor who would benefit directly from any recovery obtained. Under these or similar criteria (always subject to the protection that the Bankruptcy Court, as advised by the SEC, must approve the initiation of the action) a

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* As Judge Kaufman below stated, "not performed merely by a nice, sharp, precise and mathematical apportionment of a debtor's estate according to fixed formulas", but by "a process of negotiation, and some give-and-take, in an attempt to adjust equitably . . . the rights of competing interested parties." (99a-100a).

** *In re Continental Vending Corp.*, E.D.N.Y. 63-B-663, and *In re Dilbert's Leasing & Development Corp.*, E.D.N.Y. 63-B-148 (See Pet. Br. 30-31).

Chapter X Trustee does (and should) have standing to prosecute claims against a wrongdoing indenture trustee on behalf of debenture holders.

Such a standing rule would be neither inconsistent with the statutory language nor at odds with the statutory scheme. The error in Marine's attempt to restrict the effect of Section 187 of the Bankruptcy Act, 11 U.S.C. Sec. 587, by reading this Court's decision in *McCandless* v. *Furlaud*, 296 U. S. 140 (1935) as limited to the issue of estoppel (Resp. Br. 35) is underscored by the very passage from Mr. Justice Cardozo's decision in that case upon which Marine relies. The "wrong" here, as in *McCandless*, is the "unlawful depletion of the [debtor's] assets" in violation of the indenture, an unlawful depletion made possible only through the complicity or gross negligence of Marine.*

3. Indeed, Marine, in urging that the inquiry be limited to the status of the Trustee's claim as property of the estate, retreats even from the alternate inquiry suggested in *Clarke* and by the majority below as to whether the claim would affect the plan of reorganization. This strategic retreat is understandable in light of the erroneous conclusion by the court below on the question of subrogation, namely, that if the Trustee prevailed "Marine would simply be substituted for the debentureholders as the claimant" (92a). Marine does not even attempt to defend this blanket conclusion or the mistaken reliance by the Court below on the Restatement of Security (see Pet. Br. 26-28),

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* Moreover, Marine ignores Section 212 of the Bankruptcy Act, 11 U.S.C. Sec. 612, which sets forth express authority to compel an accounting by an indenture trustee, from which the Third Circuit concluded in *In re Solar Mfg. Corp.*, 200 F. 2d 327 (3d Cir. 1952), that the Chapter X trustee could counterclaim to such an account. Even granting Marine's tenuous interpretation (with which we do not agree) of Judge Learned Hand's opinion in *Prudence-Bonds*, the Third Circuit's decision in *Solar* totally belies Marine's claim to the support of *all* the courts which have previously dealt with the problem (Resp. Br. 12).

but now argues only that the Trustee really meant to allege only simple negligence rather than "gross negligence or wilful misconduct" and that therefore Marine's wrongdoing "*almost* certainly could not involve the type of culpability which sometimes leads to a denial of subrogation rights" (Resp. Br. 26-27, emphasis added). It is submitted, however, that the Trustee, not Marine, knows best what he intended to, and did, allege.

4. Marine also suggests that the Chapter X process might itself be undermined if the Trustee here is found to have standing, because a Chapter X trustee might delay consummation of a plan of reorganization while pursuing a claim against the indenture trustee (Resp. Br. 46).* The fact is, however, that trustees, whenever they are involved in litigation (even suits involving "property" of the estate as defined by Marine), must make a judgment as to whether to delay submission of a plan pending resolution of litigation or to submit a plan which makes reference to pending litigation and provision for a subsequent distribution of any recoveries obtained. The trustee's judgment in such instances—as it would be in the case of his action on behalf of debenture holders against the indenture trustee—is subject to the scrutiny of both the reorganization court and the SEC.

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* On the other hand, Marine argues that, because the Trustee here *has* submitted a plan to the reorganization court for consideration, the issue of his standing is now moot (Resp. Br. 27). That a plan has been submitted does not detract in the slightest from the *significant relationship* between the debtor's affairs and the subject matter of the action. Even assuming every argument made by Marine with respect to the issue of subrogation, the fact remains that at the very minimum, if the Trustee succeeds on the merits, a large class of debt investors will have been made whole (Pet. Br. 26-27).

POINT II.

The Trustee neither attempts to subvert the intent of Rule 23 nor to preempt other actions, but rather seeks only to provide the best representation for debenture holders under all the circumstances.

1. Marine charges that the Trustee is a "self-appointed volunteer" who would "undermine the mechanism of [Federal] Rule 23" (Resp. Br. 39). In this respect, the charge is made that the Trustee omitted Rule 23 "from his catalogue of measures enacted by Congress for the protection of investors" (Resp. Br. 20), apparently in order to further his devious scheme of thwarting the path of debenture holders whose rights Marine has stepped forth so recently to champion. The fact, as opposed to this "phantom" created by Marine, is that the Trustee has argued in favor of a procedure with not only the safeguards and benefits of Rule 23 (Pet. Br. 21), but with the additional protection that all steps, including the initial commencement of the action and any settlement thereof, would take place only with the approval of the reorganization court and under the watchful eye of the SEC.*

Marine argues that in view of Rule 23, debenture holders do not need (and should not have) a representative from outside their ranks to prosecute claims on their behalf relating to the indenture. Precisely this argument was rejected by Congress in enacting the Trust Indenture Act of 1939, one year after the codification of Rule 23. Trust Indenture Act § 302(a)(1), 15 U.S.C. § 77bbb(a)(1). (Pet.

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* This Court's recent decision in *State of Hawaii* v. *Standard Oil Co. of California*, No. 70-49, (March 1, 1972), 40 U.S.L.W. 4246, offers Marine no more than another "phantom" to flail away at (Resp. Br. 44). The Trustee here makes no claim to be acting in a *parens patriae* capacity, and the issue in the *State of Hawaii* antitrust action concerned the limits of damages under Sec. 4 of the Clayton Act and not the question of standing at all.

Br. 19.) The same considerations which militate in favor of having a representative (the indenture trustee) to protect debenture holders' rights under the indenture militate in favor of having a representative (the Chapter X trustee) to protect debenture holders' rights vis-a-vis the indenture trustee.

2. Marine points to the pendency of two debenture holders' actions in state and federal court and frames the issue before this Court as a *choice* between allowing the Trustee's action to proceed on the merits or allowing the other actions to proceed (Resp. Br. 7-9, 39-44). No such *choice*, however, is before this Court.

No attempt is made here by the Trustee to "preempt" or diminish the rights of investors, but only to augment the means of enforcing them. Permitting reorganization trustees to sue indenture trustees does not preclude investors from doing so as well, either individually or collectively. The real question is whether the rights of investors are to be made meaningful by permitting reorganization trustees to assert them. In this context, it is highly significant that Marine has nowhere denied that reorganization trustees are in a far better position than debt investors to discover, prosecute and prove claims based on the indenture trustee's failure to enforce covenants in the trust indenture (See Pet. Br. 17-19).

There is no question that individual debenture holders may prosecute their own claims against Marine. If the rule of *Elkind* v. *Chase National Bank*, 259 A. D. 661, 20 N.Y.S.2d 213, *aff'd* 284 N.Y. 726, 31 N.E.2d 198 (1940) is rejected by the New York courts (despite Marine's opposition) the most serious *legal* impediment to the maintenance of such class actions will also have been set aside.

The Trustee *never* has argued that class actions by debenture holders should not or cannot proceed in the face of an action by the Trustee. What the Trustee *has* argued,

and what Marine has totally side-stepped, is that a Chapter X trustee is in the best position to prosecute such an action (Pet. Br. 17-22) and that the commencement of such an action by the Chapter X trustee is likely to persuade bondholders that their rights are protected and therefore influence them *not* to commence additional suits. In this respect, the facts relating to the instant accumulation of lawsuits are most illustrative. Here the debenture holders' suits (Pet. Br. 21, n. 9) were commenced

> *after* the Trustee had conducted his investigation and made his report to the reorganization court pursuant to Section 167(3) of the Bankruptcy Act,*
>
> *after* the Trustee had obtained authorization from the reorganization court to commence the action against Marine, and,
>
> most importantly, *after* Marine had interposed objections as to the Trustee's standing.

In this situation, given the uncertain state of the Trustee's standing, at least in the Second Circuit, had the debenture holders, refrained from commencing separate actions against Marine, based on the information made available in the Trustee's petition for authorization to commence the action, they would have run the risk of having their rights vis-a-vis Marine totally wiped out by the statute of limitations. It is this very pressure to sue, and its result in a proliferation of class actions in state and federal courts, that is accentuated by the holding of the court below.**

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* Were it not for the Trustee's Section 167 investgation, Marine's wrongdoing might have gone totally unexposed.

** Marine's suggestion that the Trustee is somehow to blame for the delays in the separate debenture holder actions is pure myth. (Resp. Br. 39.) The *Ray* case has been delayed in state court because Marine has filed an appeal urging the state court to follow the *Elkind* rule. The *Lewis* case has been stayed on the application of Marine which was based on the pendency of this action. Marine's belated con-

3. Marine also makes vague allusions to the possibility of double recovery if the Trustee is permitted to proceed with his action, while debenture holders proceed simultaneously with causes of action based on alleged securities law violations (Resp. Br. 45, n. 18). Such a possibility is no more real than in the situation where investors simultaneously pursue common law fraud actions in state court and 10b-5 actions in federal court. Marine need only "speak up" in the second forum to assure that it is properly credited with any recovery previously obtained against it. What Marine is seeking is not to prevent double recovery but to prevent its being called upon to account at all, even once, for its wrongful acts.

4. Marine's further charge that a Chapter X trustee might "face conflicts between positions taken in litigation on behalf of the estate and related claims belonging to others" (Resp. Br. 46) is likewise made of whole cloth. In the instant action no such conflict exists (nor has it ever been alleged by Marine). Furthermore, whenever any such conflict is alleged to exist, such allegations can be brought to the attention of the reorganization court by any interested party when permission is sought by the trustee to institute suit. Finally, as added protection, the fact remains that key litigation decisions, from the initial commencement of the action to its conclusion, including any proposed settlement, are always subject to the approval and review of the reorganization court itself.

In summary, the Trustee seeks only the opportunity to proceed on the merits to recover losses on behalf of debt investors sustained as a result of Marine's wilful miscon-

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cern for the rights of debentureholders which it is asserted that the Trustee is attempting to "preempt" is belied not only by Marine's constant and vigorous opposition to these separate actions on the grounds that they cannot properly be brought as *class* actions (Pet. Br. 21, n. 9), but, in addition, by the fact that not a single debenture holder has opposed the Trustee's efforts to prosecute the instant action. Moreover, Marine seems to be saying that the later brought *Ray* and *Lewis* actions in fact "preempt" the Trustee's suit.

duct or gross negligence in failing to enforce provisions of the indenture. In so doing, the Trustee acts in accord with the statutory language and in furtherance of the policies of the Chandler and Trust Indenture Acts and with the full support of the debt investors whom he represents.

CONCLUSION

For the reasons stated, the judgment of the Court of Appeals should be reversed and the cause remanded to the District Court.

Respectfully submitted,

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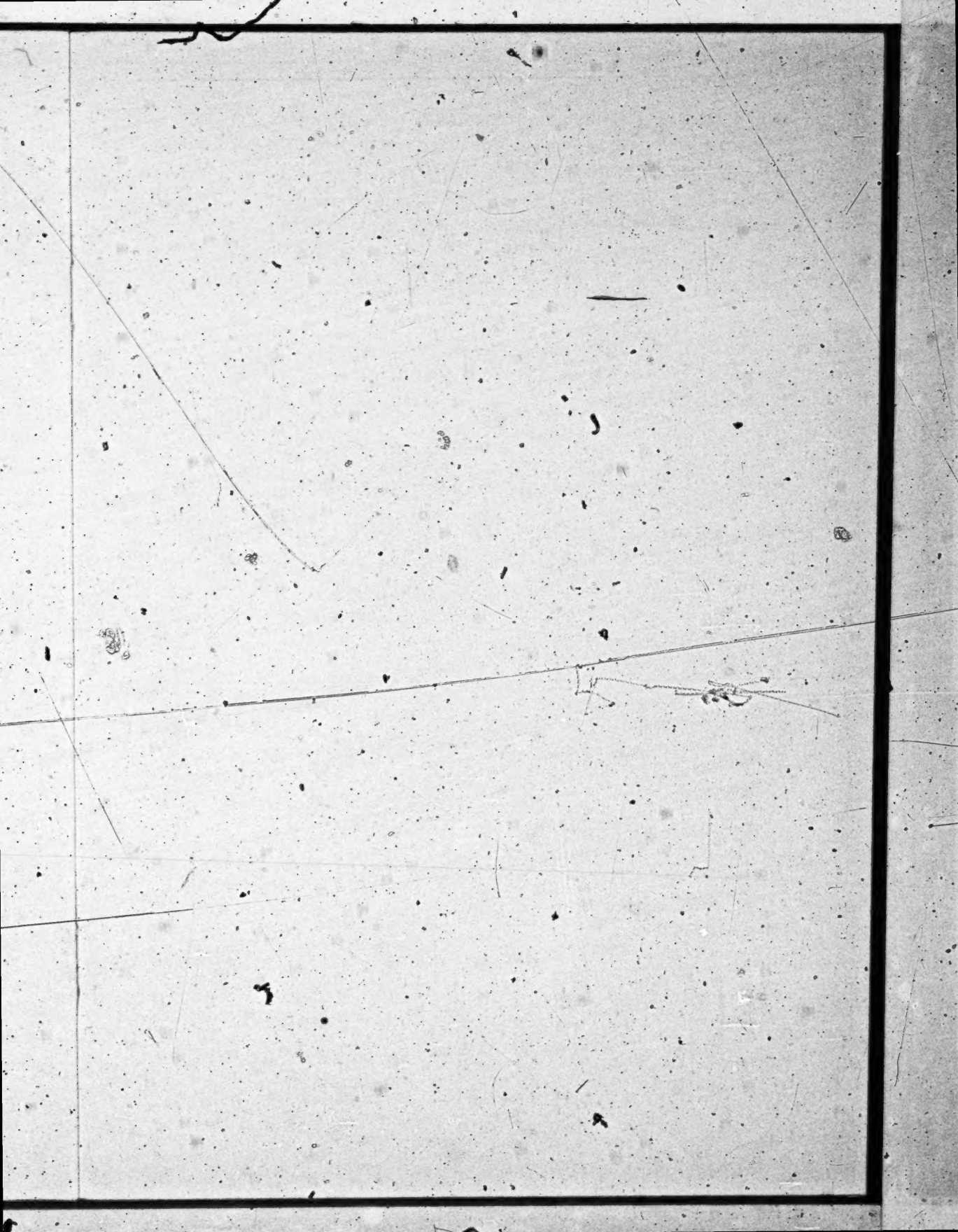

CAPLIN, TRUSTEE *v.* MARINE MIDLAND GRACE TRUST CO. OF NEW YORK

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 70-220. Argued March 28, 1972—Decided May 22, 1972

Petitioner, the trustee of Webb & Knapp, Inc., under Chapter X of the Bankruptcy Act, does not have standing to assert, on behalf of holders of debentures issued by Webb & Knapp, claims of misconduct by an indenture trustee. Pp. 417–435.

439 F. 2d 118, affirmed.

MARSHALL, J., delivered the opinion of the Court, in which BURGER, C. J., and STEWART, POWELL, and REHNQUIST, JJ., joined. DOUGLAS, J., filed a dissenting opinion, in which BRENNAN, WHITE, and BLACKMUN, JJ., joined, *post*, p. 435.

Charles H. Miller argued the cause for petitioner. With him on the briefs were *Mortimer M. Caplin, pro se*, *Henry Winestine*, and *Leon E. Irish*.

John W. Dickey argued the cause and filed a brief for respondent.

David Ferber argued the cause for the Securities and Exchange Commission urging reversal. With him on the briefs were *Solicitor General Griswold*, *Samuel Huntington*, *G. Bradford Cook*, and *Paul Gonson*.

MR. JUSTICE MARSHALL delivered the opinion of the Court.

The sole issue in this case is whether petitioner, the trustee in reorganization of Webb & Knapp, Inc., has standing under Chapter X of the Bankruptcy Act, 52 Stat. 883, 11 U. S. C. § 501 *et seq.*, to assert, on behalf of persons holding debentures issued by Webb & Knapp, claims of misconduct by an indenture trustee. The United States District Court for the Southern District

of New York held that petitioner lacked the requisite standing, and the United States Court of Appeals for the Second Circuit affirmed *en banc*, with two judges dissenting, 439 F. 2d 118 (1971).[1] We granted certiorari, 404 U. S. 982 (1971), and we now affirm the decision of the Court of Appeals.

I

Webb & Knapp and its numerous subsidiaries were engaged in various real estate activities in both the United States and Canada. In 1954, the corporation executed an indenture with respondent, the Marine Midland Trust Company of New York (Marine), that provided for the issuance by Webb & Knapp of 5% debentures in the total amount of $8,607,600. A critical part of the indenture was the promise by Webb & Knapp that neither it nor any company affiliated with it[2] would incur or assume "any indebtedness resulting from money borrowed or from the purchase of real property or interests in real property . . . or purchase any real property or interests in real property" unless the company's consolidated tangible assets, as defined in the indenture, equaled 200% of certain liabilities, after giving effect to the contemplated indebtedness or purchase.[3]

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[1] The District Court delivered three separate opinions in this case. They are unreported, but are included in the appendix prepared by the parties at 58a–70a. The Court of Appeals heard the case *en banc* after a panel of three judges determined that it was inclined to overrule the case on which the District Court had placed almost exclusive reliance. 439 F. 2d 118.

[2] Those companies in the affiliated group include any corporation that was entitled to be included in a consolidated tax return of Webb & Knapp. See 26 U. S. C. § 1502. Section 1.1 of the Indenture gave Webb & Knapp authority to consider other companies as affiliates if it chose to do so.

[3] Indenture of June 1, 1954, Webb & Knapp, Inc., to the Marine Midland Trust Company of New York § 3.6 (hereinafter referred to as Indenture).

By requiring the company to maintain an asset-liability ratio of 2:1, the indenture sought to protect debenture purchasers by providing a cushion against any losses that the company might suffer in the ordinary course of business. In order to demonstrate continuing compliance with the requirements of the indenture, Webb & Knapp covenanted to file an annual certificate with Marine stating whether the corporation (debtor) had defaulted on any of its responsibilities under the indenture during the preceding year.[4]

In its role as indenture trustee, Marine undertook "in case of default . . . to exercise such of the rights and powers vested in it by [the] Indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."[5] This undertaking was qualified by language in the indenture that permitted the trustee to rely on the accuracy of certificates or reports of Webb & Knapp, in the absence of bad faith.[6]

Commencing in 1959, Webb & Knapp sustained substantial financial losses in every year.[7] Finally, on May 7, 1965, Marine filed a petition in district court seeking the involuntary reorganization of Webb & Knapp under Chapter X of the Bankruptcy Act, 11 U. S. C. § 501 *et seq.* Pursuant to § 208 of Chapter X, 11 U. S. C. § 608, the Securities and Exchange Commission inter-

[4] Indenture § 3.11.

[5] Indenture § 10.1 (a). This was also a statutory duty. See 15 U. S. C. § 77*ooo*.

[6] Indenture § 10.1 (d).

[7] Webb & Knapp showed a loss for tax purposes each year, although the company did show a gain on its books for 1961 attributable to a write-up of property owned by a wholly owned subsidiary of a company in which Webb & Knapp held 50% of the stock.

vened on May 10, 1965.[8] Marine's petition was subsequently approved and petitioner was appointed trustee in reorganization on May 18, 1965.

With the approval of the District Court, petitioner exercised the powers conferred upon him by 11 U. S. C. § 567 and undertook an extensive investigation of the financial affairs of Webb & Knapp. His investigation showed that the company had total assets of $21,538,621 and total liabilities of $60,036,164, plus contingent tax liabilities of $29,400,000. Included among the liabilities were the 1954 debentures in the principal amount of $4,298,200 plus interest subsequent to the inception of the reorganization proceeding.[9]

The investigation led petitioner to conclude that Marine had either willfully or negligently failed to fulfill its obligations under the indenture. Petitioner supported his conclusion with the following allegations: that from 1954 to 1964, Webb & Knapp's yearly certificates of compliance with the 2:1 asset-liability ratio mandated by the indenture were fraudulent, because they were based on grossly overvalued appraisals of real estate property; that from 1958 to 1964, Webb & Knapp did not have sufficient assets to comply with the terms of the indenture; that Marine should have known or did know of the inflated appraisals; and that because Marine permitted Webb & Knapp to violate the indenture by engaging in transactions that its impaired asset-liability

[8] The SEC has supported petitioner throughout this litigation. The agency is "an unnamed respondent before this Court." See *Protective Committee v. Anderson*, 390 U. S. 414, 420 n. 3 (1968). When referring to arguments made by petitioner, this opinion assumes, unless otherwise stated, that the SEC has made the same arguments.

[9] The difference between this amount and the amount of the debentures originally issued represents the amount of the principal that Webb & Knapp had repaid.

ratio forbade, Webb & Knapp suffered great financial losses.[10]

Having obtained the approval of the District Court, petitioner filed an independent action on behalf of the debenture holders against Marine seeking to recover the principal amount of the outstanding debentures as damages for Marine's alleged bad-faith failure to compel compliance with the terms of the indenture by Webb & Knapp. Petitioner also filed a counterclaim in the same amount against Marine in the reorganization proceeding in which Marine had previously filed a claim for services rendered. In the reorganization proceeding, petitioner also filed an objection to the claim for services rendered, on the ground that even if petitioner could not obtain an affirmative recovery against Marine on behalf of the bondholders, he could at least raise Marine's improper conduct as a reason why the claim for services rendered should be denied.[11] Finally, petitioner moved to compel an accounting by Marine.

Marine moved to dismiss the independent action and the counterclaim, moved to strike the objection to the claim for services rendered, and opposed the motion to compel an accounting. The District Court found that petitioner had no standing in his capacity as a trustee in reorganization under Chapter X of the Bankruptcy Act to raise claims of misconduct by an indenture trustee on behalf of debenture holders and granted both of Marine's motions to dismiss. Viewing the motion to compel an accounting as merely a third vehicle to raise the same

[10] These are merely allegations of petitioner, not findings of the lower courts. Because the District Court and the Court of Appeals held that petitioner had no standing, they had no occasion to consider the validity of the allegations.

[11] In its capacity as indenture trustee, Marine also filed a claim on behalf of all the debenture holders for the unpaid principal on the debentures.

claim on behalf of the debenture holders, the District Court denied that motion also. Only petitioner's objection to the claim for services rendered was left standing.[12] Petitioner appealed the dismissal of his claims and the denial of his motion for an accounting to the Court of Appeals. Marine filed a cross-appeal from the denial of its motion to strike petitioner's objection to the claim for services rendered. The Court of Appeals affirmed the decision of the District Court in its entirety.

II

The issue confronting us has never before been presented to this Court. It is an issue that has only rarely been presented to other courts, and on those rare occasions, it has caused even the most able jurists to disagree. The first time the issue arose was in *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (CA2 1943). Judge Augustus Hand wrote the opinion of the court holding that a trustee in reorganization did not have standing to sue a third party on behalf of bondholders. Judge Learned Hand disagreed and dissented. It is this decision that the lower courts found controlling in the instant case. The *Clarke* case is, in fact, the only other case in which the issue that is raised here was squarely presented.[13]

[12] This objection differs from the other claims in one respect: i. e., it is an attempt to preserve the remaining assets of the debtor for all creditors other than Marine, whereas the other claims represent an attempt by the petitioner to increase the assets of the debtor for the benefit of a specific class of creditors, the debenture holders. Although Marine appealed the ruling of the District Court denying its motion to strike the objection, it did not seek review here of the decision of the Court of Appeals affirming the District Court on this issue. This issue is, therefore, not before us, and we offer no opinion on the propriety of the lower courts' ruling.

[13] Petitioner and the two dissenting judges in the Court of Appeals argue that the issue was presented in *Prudence-Bonds Corp.* v. *State Street Trust Co.*, 202 F. 2d 555 (CA2), cert. denied, 346 U. S. 835

The issue is a difficult one, and, as we point out later, it is one that is capable of resolution by explicit congressional action. Lacking a specific legislative statement on this issue, we must resolve it as best we can by examining the nature of Chapter X proceedings, the role of the trustee in reorganization, and the way in which standing to sue on behalf of debenture holders would affect or change that role.

Chapter X, enacted in 1938, stemmed from a comprehensive SEC study that disclosed widespread abuses under the then-existing provisions for business reorganizations. See Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937–1940). This same study gave birth the following year to the Trust Indenture Act of 1939, 53 Stat. 1149, 15 U. S. C. § 77aaa *et seq.*, which is discussed *infra*.

In enacting Chapter X, Congress had protection of public investors primarily in mind. *SEC* v. *American Trailer Rentals Co.*, 379 U. S. 594 (1965). "The aims of Chapter X . . . were to afford greater protection to creditors and stockholders by providing greater judicial control over the entire proceedings and impartial and expert administrative assistance in corporate reorganizations through appointment of a disinterested trustee and the active participation of the SEC." *Id.*, at 604. In

(1953), and that the decision of the court in that case by Judge Learned Hand overruled *Clarke* v. *Chase National Bank*, 137 F. 2d 797 (CA2 1943), *sub silentio*. They also argue that the issue was presented and decided contrary to *Clarke* in *In re Solar Manufacturing Corp.*, 200 F. 2d 327 (CA3 1952), cert. denied *sub nom. Marine Midland Trust Co.* v. *McGirl*, 345 U. S. 940 (1953). But, the majority of the Court of Appeals found these cases to be distinguishable, and Marine urges that the majority was correct. We do not intend to become enmeshed in this controversy and merely indicate its existence.

contradistinction to a bankruptcy proceeding where liquidation of a corporation and distribution of its assets is the goal, a Chapter X proceeding is for purposes of rehabilitating the corporation and reorganizing it. *Ibid.* Chapter X proceedings are not limited to insolvent corporations but are open to those corporations that are solvent in the bankruptcy (asset-liability) sense but are unable to meet their obligations as they mature. *United States* v. *Key*, 397 U. S. 322, 329 (1970); 11 U. S. C. § 530 (1).

The trustee in reorganization is the center of the statutory scheme. H. R. Rep. No. 1409, 75th Cong., 1st Sess., 43, 44. Title 11 U. S. C. § 567 gives the trustee broad powers:

> "The trustee upon his appointment and qualification—
>
> "(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;
>
> "(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;
>
> "(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;
>
> . . . . .
>
> "(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and

the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

"(6) shall give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans, within a time therein named."

Title 11 U. S. C. § 587 expands these powers:

"Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 72 of this title, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor."

The powers given a trustee appointed under § 72 are set forth in a footnote.[14]

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[14] Title 11 U. S. C. § 110 gives the trustee title to the following "property":

"(a) The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title . . . to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trade-marks, and in applications therefor . . . (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person, (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and

Petitioner argues that these powers are broad enough to encompass a suit on behalf of debenture holders against an indenture trustee who has acted in bad faith, and who has, therefore, violated the indenture and the Trust Indenture Act of 1939, 15 U. S. C. § 77aaa *et seq.*

As pointed out above, the Trust Indenture Act was passed one year after Chapter X was enacted. Prior to its enactment, indenture trustees immunized themselves from any liability for either deliberate or negligent misconduct by writing exculpatory provisions into the indenture. Even in cases where misconduct by the indenture trustee was the proximate cause of injury to debenture holders, they found themselves impotent under the terms of most indentures to take action against the trustee. See generally 2 L. Loss, Securities Regulation 719–725 (2d ed. 1961). This problem and others are specifically mentioned in 15 U. S. C. § 77bbb as establishing a necessity for regulation.

The regulation provided by the Act takes many forms. 15 U. S. C. § 77eee requires that whenever securities covered by the Trust Indenture Act are also covered by the registration provisions of the Securities Act of 1933, 48 Stat. 74, 15 U. S. C. § 77a *et seq.*, certain information about the indenture trustee and the terms of the in-

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sold under judicial process against him, or otherwise seised, impounded, or sequestered . . . (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were non-assignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this title, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court."

denture must be included in the registration statement. Title 15 U. S. C. § 77ggg provides that when securities are not registered under the 1933 Act but are covered by the Trust Indenture Act, the indenture must be "qualified" by the SEC before it is legal to sell the securities. Standards for eligibility and disqualification of a trustee are established by 15 U. S. C. § 77jjj, and the duties and responsibilities of a trustee are enumerated in 15 U. S. C. § 77*ooo*.[15]

The indenture giving rise to this litigation was qualified by the SEC pursuant to the Trust Indenture Act of 1939. By alleging that the indenture trustee negligently or intentionally failed to prevent Webb & Knapp from violating the terms of the indenture, petitioner clearly alleges a violation of the 1939 legislation, 15 U. S. C. § 77*ooo*.[16] But the question remains whether petitioner is a proper party to take corrective action.[17]

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[15] The SEC is given general supervisory powers over indentures in various sections of the Trust Indenture Act. See, *e. g.*, 15 U. S. C. §§ 77ddd (c), (d), (e); 77eee (a), (c); 77ggg; 77sss; 77ttt; 77uuu. In addition, 15 U. S. C. § 77hhh provides that the SEC may order consolidation of reports or certificates filed under the Trust Indenture Act with information or documents filed under the Securities Act of 1933, 48 Stat. 74, 15 U. S. C. § 77a *et seq.*, and the Securities Exchange Act of 1934, 48 Stat. 881, 15 U. S. C. § 78a *et seq.*, the Public Utility Holding Company Act of 1935, 49 Stat. 838, 15 U. S. C. § 79 *et seq.*

[16] The provisions of the indenture discussed previously comply with the requirements of 15 U. S. C. § 77*ooo*. While the indenture trustee is not permitted by the statute to exculpate himself from liability for noncompliance with the indenture, the indenture trustee may rely in good faith on certificates or reports filed pursuant to the indenture and in compliance with the provisions thereof.

[17] We assume, *arguendo*, that violation of 15 U. S. C. § 77*ooo* would give rise to a cause of action against an indenture trustee by debenture holders. If there is a cause of action, 15 U. S. C. § 77vvv would seem to give federal courts exclusive jurisdiction. The Court of Appeals inferred that such suits would be proper, 439 F. 2d, at 123 n. 5, but did not decide the point. Since we conclude that even

Petitioner urges that the reorganization trustee is in a far better position than debt investors to discover and to prosecute claims based on the alleged failure of an indenture trustee to live up to the provisions of the indenture. He points to 11 U. S. C. § 567, set forth *supra*, and emphasizes that not only does the reorganization trustee have possession of the records of the debtor, but he also has a statutory duty to investigate the debtor's affairs and to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate." Reference is made, too, to 15 U. S. C. § 77bbb (a)(1), which states that one of the problems Congress saw with respect to misconduct by indenture trustees was that "(A) individual action by . . . investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and (B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors." [18]

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if such suits may be brought, petitioner lacks standing to bring them, we do not decide the question.

[18] It should be noted that the Trust Indenture Act of 1939 was enacted on August 3, 1939. The Federal Rules of Civil Procedure were not even one year old. They were adopted by this Court on December 20, 1937, and they became effective on September 16, 1938, 308 U. S. 647. The class action was a comparatively recent phenomenon with respect to damage actions and it was not tremendously helpful in the early days. See, e. g., Moore, Federal Rules of Civil Procedure: Some Problems Raised by the Preliminary Draft, 25 Geo. L. J. 551, 570-576 (1937); Kalven & Rosenfield, The Contemporary Function of the Class Suit, 8 U. Chi. L. Rev. 684 (1941). It could not be said that the class action was an efficacious remedy in 1939.

Finally, petitioner asserts that to give him standing to sue on behalf of debenture holders will not encourage vexatious litigation or unduly deplete the resources of the debtor that he has been appointed to reorganize. He supports the first half of this proposition by noting that any action he takes is subject to the supervision of the District Court and to intervention by the SEC. The second half of the proposition finds support in the argument discussed above that petitioner already has a duty of investigation and that the minimal additional burden of prosecuting a lawsuit will not be great.

At first blush, petitioner's theory, adopted in the opinion of the dissenters in the Court of Appeals, seems reasonable. But, there are three problems with petitioner's argument and these problems require that his position be rejected.

First, Congress has established an elaborate system of controls with respect to indenture trustees and reorganization proceedings, and nowhere in the statutory scheme is there any suggestion that the trustee in reorganization is to assume the responsibility of suing third parties on behalf of debenture holders. The language, in fact, indicates that Congress had no such intent in mind. The statute, 11 U. S. C. § 567 (3), gives the trustee the right, and indeed imposes the duty, to investigate fraud and misconduct and to report to the judge the potential causes of action "available to the estate." Even assuming that this section is read as if the quoted words were not present, and that it authorizes a trustee in reorganization to report whether he believes an indenture trustee has violated a duty to third-party debenture holders, there is nothing in the section that enables him to collect money not owed to the estate. Nor is there anything in 11 U. S. C. § 110, set forth in relevant part in footnote 14, *supra*, that gives him this authority. His task is simply to "collect and reduce to

money the property of the estates for which [he is trustee]." 11 U. S. C. § 75.

The only support petitioner finds in the relevant statutes is in that portion of 11 U. S. C. § 587 which gives reorganization trustees the additional rights that a "receiver in equity would have if appointed by a court of the United States for the property of the debtor." Petitioner relies on *McCandless* v. *Furland*, 296 U. S. 140 (1935), to support the proposition that a receiver in equity may sue third parties on behalf of bondholders. But, the opinion of the Court by Mr. Justice Cardozo clearly emphasizes that the receiver in that case was suing on behalf of the corporation, not third parties; he was simply stating the same claim that the corporation could have made had it brought suit prior to entering receivership.[19] The debtor corporation makes no such claim in this case. See generally 2 R. Clark, Law and Practice of Receivers § 362, at 619 (3d ed. 1959).

This brings us to the second problem with petitioner's argument. Nowhere does petitioner argue that Webb & Knapp could make any claim against Marine. Indeed, the conspicuous silence on this point is a tacit admission that no such claim could be made.[20] Assuming that

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[19] This point is especially clear in light of the fact that the Court split 5–4 on whether *Old Dominion Copper Co.* v. *Lewisohn*, 210 U. S. 206 (1908) (Holmes, J.), was binding in *McCandless* v. *Furland*. The issue in the controversial *Old Dominion* case was whether *a corporation* had a cause of action against promoter-director-stockholders.

[20] If petitioner could sue on behalf of Webb & Knapp, the statute that requires that he report possible causes of action to the court would require mention of this cause of action. Moreover, petitioner has brought every conceivable claim that is available to him as trustee. Not only has he brought this action against the indenture trustee, but he has also sued former officers of Webb & Knapp charging them with waste. Brief for SEC 5–6. Certain settlements have apparently been made in some of these other actions. Brief for Respondent 45 n. 18.

petitioner's allegations of misconduct on the part of the indenture trustee are true, petitioner has at most described a situation where Webb & Knapp and Marine were *in pari delicto*. Whatever damage the debenture holders suffered, under petitioner's theory Webb & Knapp is as much at fault as Marine, if not more so. A question would arise, therefore, whether Marine would be entitled to be subrogated to the claims of the debenture holders. The Court of Appeals thought that subrogation would be required, 439 F. 2d, at 122.

If the Court of Appeals is correct, it is then difficult to see what advantage there is in giving petitioner standing to sue, for as Chief Judge Friendly noted in his opinion for the court below:

> "It is necessary in the first instance to consider what effect a recovery by the Chapter X Trustee would have on the reorganization. On a superficial view this might seem substantial—if, for example, the Chapter X Trustee were to achieve a complete recovery, the debenture holders would be paid off and it might seem there would be that much more for the other creditors and the stockholders. But this pleasant prospect speedily evaporates when the law of subrogation is brought into play. As a result of subrogation, Marine would simply be substituted for the debenture holders as the claimant. Cf. ALI, Restatement of Security § 141 (1941). If the Chapter X Trustee recovered judgment in a lesser amount, the claim of the debenture holders would still be provable in full, with the division of the proceeds between them and Marine dependent upon the results of the reorganization, and other creditors or stockholders would not be affected." 439 F. 2d, at 122.

Even if the Court of Appeals is incorrect in its view of the propriety of subrogation under the facts of this case,

the fact remains that in every reorganization there is going to be a question of how much the trustee in reorganization should be permitted to recover on behalf of the debenture holders. The answer is, of course, whatever he cannot recoup from the corporation. Once this is recognized, the wisdom of Judge Augustus Hand in *Clarke v. Chase National Bank*, 137 F. 2d, at 800, becomes readily apparent:

> "Each creditor, including the debenture-holders, can prove the full amount of his claim, and only to the extent that a debenture-holder fails to satisfy it from the bankruptcy estate will he suffer a loss which he can assert against the defendant through its failure to enforce the negative covenants."

In other words, debenture holders will not be able to recover damages from the indenture trustee until the reorganization is far enough along so that a reasonable approximation can be made as to the extent of their losses, if any. It is difficult to see precisely why it is at that point that the trustee in reorganization should represent the interests of the debenture holders, who are capable of deciding for themselves whether or not it is worthwhile to seek to recoup whatever losses they may have suffered by an action against the indenture trustee. Petitioner appears to concede that any suit by debenture holders would not affect the interests of other parties to the reorganization, assuming that the Court of Appeals is correct on the subrogation point. It would seem, therefore, that the debenture holders, the persons truly affected by the suit against Marine, should make their own assessment of the respective advantages and disadvantages, not only of litigation, but of various theories of litigation.

This brings us to the third problem with petitioner's argument: i. e., a suit by him on behalf of debenture holders may be inconsistent with any independent actions

that they might bring themselves. Petitioner and the SEC make very plain their position that a suit by the trustee in reorganization does not pre-empt suits by individual debenture holders. They maintain, however, that it would be unlikely that such suits would be brought since the debenture holders could reasonably expect that the trustee would vigorously prosecute the claims of all debt investors. But, independent actions are still likely because it is extremely doubtful that the trustee and all debenture holders would agree on the amount of damages to seek, or even on the theory on which to sue.[21] Moreover, if the indenture trustee wins the suit brought by the trustee in reorganization, unless the debenture holders are bound by that victory, the proliferation of litigation that petitioner seeks to avoid would then ensue. Finally, a question would arise as to who was bound by any settlement.[22]

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[21] Three private actions have been brought by debenture holders against Marine, one in federal court and two in state court. See Brief for Petitioner 21 n. 9. These suits make the same claims made by the petitioner in the instant case, as well as others which he has not made, including alleged violations of the securities laws.

The trustee may well have interests that differ from those of the bondholders. For example, petitioner has sued not only Marine, but also the former officers of Webb & Knapp. See n. 20, *supra*. In settling the suits brought against the officers, petitioner may well take positions that conflict with those he would take in a suit against Marine. The conflict may at times be unfavorable to the debenture holders. One answer obviously is that the District Court and the SEC can take action to prevent any such conflict from developing, *e. g.*, by denying the trustee in reorganization the right to sue on behalf of debenture holders in selected cases. The problem with this answer is that the conflict may not appear until the suit is well under way. In such a case the debenture holders might regret placing their confidence in the trustee.

[22] Chapter X, 11 U. S. C. § 616 (2), provides that a plan for reorganization "may deal with all or any part of the property of the debtor." It also provides that the plan "may include provisions for the settlement or adjustment of claims belonging to the debtor

Rule 23 of the Federal Rules of Civil Procedure, which provides for class actions, avoids some of these difficulties. It is surely a powerful remedy and one that is available to all debenture holders.[22] Some of the factors that formerly deterred such actions have been changed by the Trust Indenture Act of 1939. Title 15 U. S. C. § 77*lll*, for example, now requires that the debtor corporation maintain lists of debenture holders that it must turn over to the indenture trustees at regular intervals. Such lists are available to the individual de-

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or to the estate." 11 U. S. C. § 616 (13). Despite these provisions, petitioner urges, in effect, that he can settle a suit on behalf of bondholders without binding them to the settlement. Reply Brief for Petitioner 7–8. But, as pointed out in the text, *supra*, petitioner only has authority to pursue claims belonging to the estate. Petitioner is thus caught on the horns of a dilemma; either he is incorrect in asserting that the statutory definition of duties should be read so broadly as to allow a trustee in reorganization to treat claims by debenture holders against third parties as sufficiently related to the estate that the trustee may sue on behalf of the debenture holders; or he is correct, and § 616 would appear to permit him to bind the debenture holders to a settlement. Even if petitioner can have it both ways, his inability to bind the persons on whose behalf he sues undercuts the utility of his suing. Because the debenture holders could bring a class action and bind all members of the class, they can make a binding settlement and avoid lengthy and expensive litigation. Petitioner cannot make such a settlement. Moreover, if a reorganization trustee does settle a suit that he has brought on behalf of debenture holders, he may find that rather than serving as their representative, he is forced to oppose their interests when they bring independent actions to recover more than the settlement figure. In this event, the reorganization trustee would be forced to justify his settlement, and he would theoretically join the indenture trustee in opposing the action of the debenture holders. He would find himself on both sides of the same transaction.

[22] Again we assume, *arguendo*, that the Trust Indenture Act gives a right of action to debenture holders under these circumstances. Obviously, if the debenture holders themselves have no cause of action, their surrogate is in no better position.

benture holders upon request. Debenture holders would also be able to take advantage of any information obtained by the trustee in reorganization as a result of the investigation which the statute requires that he make. In addition, petitioner himself maintains that counsel fees would be recoverable if the action was successful. Brief for Petitioner 20; cf. 15 U. S. C. § 77nnn.

Thus, there is no showing whatever that by giving petitioner standing to sue on behalf of the debenture holders we would reduce litigation. On the contrary, there is every indication that litigation would be increased, or at least complicated.

III

For the reasons discussed above we conclude that petitioner does not have standing to sue an indenture trustee on behalf of debenture holders. This does not mean that it would be unwise to confer such standing on trustees in reorganization. It simply signifies that Congress has not yet indicated even a scintilla of an intention to do so, and that such a policy decision must be left to Congress and not to the judiciary.

Congress might well decide that reorganizations have not fared badly in the 34 years since Chapter X was enacted and that the *status quo* is preferable to inviting new problems by making changes in the system. Or, Congress could determine that the trustee in a reorganization was so well situated for bringing suits against indenture trustees that he should be permitted to do so. In this event, Congress might also determine that the trustee's action was exclusive, or that it should be brought as a class action on behalf of all debenture holders, or perhaps even that the debenture holders should have the option of suing on their own or having the trustee sue on their behalf. Any number of alternatives are available. Congress would also be able to answer questions regarding subrogation or timing of law suits before these ques-

tions arise in the context of litigation. Whatever the decision, it is one that only Congress can make.

Accordingly, the judgment of the Court of Appeals is

Affirmed.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE BRENNAN, MR. JUSTICE WHITE, and MR. JUSTICE BLACKMUN concur, dissenting.

With all respect, today's decision reflects a misunderstanding of the important role which a reorganization trustee under Chapter X of the Bankruptcy Act, 11 U. S. C. § 567, is supposed to perform. Though prior to Chapter X the debtor had usually remained in possession, Chapter X effected a basic change by putting a disinterested trustee in charge. H. R. Rep. No. 1409, 75th Cong., 1st Sess., 43–44. Working under the direction of the Court, the reorganization trustee was to make the necessary investigations concerning the debtor, the operation of its business, and the desirability of its continuance "and any other matter relevant to the proceeding or *to the formulation of a plan*, and report thereon to the judge." 11 U. S. C. § 567 (emphasis added). The reorganization trustee is, indeed, charged by 11 U. S. C. § 569 with the responsibility of formulating a plan.[1]

A Chapter X plan does not look forward to a discharge of the debtor as does ordinary bankruptcy, but rather to an overhaul of its capital structure, a simplification of it, if need be, and the determination of the

[1] 11 U. S. C. § 569 provides:

"Where a trustee has been appointed the judge shall fix a time within which the trustee shall prepare and file a plan, or a report of his reasons why a plan cannot be effected, and shall fix a subsequent time for a hearing on such plan or report and for the consideration of any objections which may be made or of such amendments or plans as may be proposed by the debtor or by any creditor or stockholder."

fair share which each class of old creditors shall receive and what participation, if any, the old stockholders may be granted. The test which the Court must ultimately apply under Chapter X is whether a plan is "fair and equitable, and feasible." 11 U. S. C. § 574. The test of "fair and equitable" derives from the old equity receiverships and was adopted in former § 77B of the Bankruptcy Act and under Chapter X.[2] As stated in the

[2] The "fixed principle" that senior interests must be made whole before junior interests may participate in a reorganization has its roots in *Northern Pacific R. Co.* v. *Boyd*, 228 U. S. 482. In that case Boyd was a general and unpaid creditor of the old corporation. In a reorganization Boyd was not fully compensated although the old stockholders were allowed to participate in the new company. He proceeded against the assets of the new venture on the ground that since the old stockholders continued in the business the latter had received property which belonged to the creditors. This Court ruled for Boyd and said "if purposely or unintentionally a single creditor was not paid, or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company." *Id.*, at 504. This principle came to be known as the "absolute priority rule." See Bonbright & Bergerman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 Col. L. Rev. 127 (1928). The rule was incorporated into equity receiverships. *Kansas City Southern R. Co.* v. *Guardian Trust Co.*, 240 U. S. 166; *Kansas City Terminal R. Co.* v. *Central Union Trust Co.*, 271 U. S. 445. Later in *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 116, we held that the absolute-priority rule was part of the gloss which the case law had placed upon the phrase "fair and equitable," language which had been used in § 77B (f)(1) of the newly enacted § 77B bankruptcy reorganization statute. 48 Stat. 919. We concluded that Congress had intended that the *Boyd* rule be carried forward. *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. 510, 527, reaffirmed this holding and further held that the requirement of absolute priority extended to cases where the debtor was solvent as well as those where the debtor was insolvent. Later we made clear that the *Boyd* requirement obtained under Chapter X. *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Co.*, 317 U. S. 78, 85–87. As recent cases reflect, the absolute-priority doc-

House Report "the [reorganization] trustee is required to assemble the salient facts necessary for a determination of the fairness and equity of a plan of reorganization." H. R. Rep. No. 1409, 75th Cong., 1st Sess., 43.

The requirements of "fair and equitable," which the Court must apply, entail the application of the absolute priority rule which we discussed at length in *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, and which was followed in *Consolidated Rock Co.* v. *Du Bois*, 312 U. S. 510. It not only gives creditors full priority over stockholders, but protects senior classes of creditors against the claim that "junior interests were improperly permitted to participate in a plan or were too liberally treated therein." 308 U. S., at 118. Unsecured creditors need not be paid in cash as a condition of stockholders retaining an interest in the reorganized company, for they may be protected by the issuance "'on equitable terms, of income bonds or preferred stock.'" *Id.*, at 117.

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trine has been continued and is firmly entrenched in Chapter X law. *E. g., Protective Committee* v. *Anderson*, 390 U. S. 414, 441; *United States* v. *Key*, 397 U. S. 322, 327 (see also concurring opinion, at 333). The reach of that doctrine, however, has not been restricted to Chapter X proceedings but has also been applied to railroad reorganizations under § 77 of the Bankruptcy Act; *Ecker* v. *Western Pacific R. Co.*, 318 U. S. 448, 484; *Group of Investors* v. *Milwaukee R. Co.*, 318 U. S. 523, 535, 571; *Reconstruction Finance Corp.* v. *Denver & R. G. W. R. Co.*, 328 U. S. 495; to dissolutions under the Public Utility Holding Company Act of 1935, 49 Stat. 838, *Otis & Co.* v. *SEC*, 323 U. S. 624, 634 (but see dissenting opinion concluding that the rule had not been faithfully followed, at 648–649); *SEC* v. *Central-Illinois Corp.*, 338 U. S. 96, 130; to Chapter IX bankruptcy proceedings, *Kelley* v. *Everglades District*, 319 U. S. 415, 420–421, n. 1; and to affirm a dismissal of a Chapter XI petition on the ground that a Chapter X reorganization would provide more protection for creditors than a Chapter XI arrangement, *SEC* v. *U. S. Realty Co.*, 310 U. S. 434, 452, 456–458. And see *General Stores Corp.* v. *Shlensky*, 350 U. S. 462, 466.

And, as we said in the *Du Bois* case:

> "If the creditors are adequately compensated for the loss of their prior claims, it is not material out of what assets they are paid. So long as they receive full compensatory treatment and so long as each group shares in the securities of the whole enterprise on an equitable basis, the requirements of 'fair and equitable' are satisfied." 312 U. S., at 530.

The face amount of the debentures in litigation here was $4,298,200. The damages sought against the indenture trustee are in the same amount. If we assume, *arguendo*, that there is merit in the cause of action and that the indenture trustee is fully responsible, one entire class of security holders is eliminated from any necessary consideration in the plan. Or if there is only partial recovery, there is a pro rata change in the relative positions of the various classes of creditors. A plan cannot be designed without a final determination of the status of the debenture holders *vis-à-vis* the indenture trustee, or at least an informed judgment concerning the value of that claim.

It is said that the assets of the debtor were some $21 million and the liabilities some $60 million. Whether conditions have changed so as to leave some equity for the old stockholders, we do not know. The rule announced by the Court today, however, is not for this case alone but applicable to all reorganizations under Chapter X. In some cases the elimination of one entire class of creditors or a pro rata reduction in their claims would give stockholders a chance to participate in the plan. There is no opportunity to make that determination without investigation, without a pursuit of claims, and without their prosecution or settlement. The reorganization trustee has full authority to do just that under the direction of the Court. And unless he can take those

steps, he will not be able to formulate a plan of reorganization for submission to the Court.

Of course, debenture holders or a protective committee representing them may in some cases take the lead. But Chapter X was written with the view that such matters should not be left to happenstance. That is why the reorganization trustee was made the "focal point" for taking an inventory of assets available to the several claimants and providing what plan would be fair and equitable in light of the security of some claimants or the payment of claims rightfully due them.[3]

There is, with all respect, no merit in the argument that, if the reorganization trustee recovers against the indenture trustee on behalf of the debenture holders, the indenture trustee will be subrogated to the debenture holders, leaving the total claims affected by the plan wholly unchanged.

The complaint against the indenture trustee charges willful misconduct or gross negligence. What the merits may be we, of course, do not know and intimate no opinion. But, if true, the Trust Indenture Act of 1939, 15 U. S. C. § 77*ooo*, gives no immunity.[4]

We said in *Pepper* v. *Litton*, 308 U. S. 295, 307, that "the bankruptcy court in passing on allowance of claims sits as a court of equity" and we cited the cases showing that claimants in a fiduciary position may have their claims either wholly disallowed or subordinated. *Id.*, at 311, 312. As stated in *American Surety Co.* v. *Bethle-*

[3] See Hearings on H. R. 8406 before a Subcommittee of the Senate Committee on the Judiciary, 75th Cong., 2d Sess., 126.

[4] While the indenture trustee may rely on certificates or opinions concerning the truth of statements and the correctness of opinions "in the absence of bad faith" (15 U. S. C. § 77*ooo* (a)(1)), it is not exempt from liability "for its own negligent action, its own negligent failure to act, or its own willful misconduct" (15 U. S. C. § 77*ooo* (d)), save for errors in judgment made in good faith. *Ibid.*

hem Bank, 314 U. S. 314, 317, while the surety is "a special kind of secured creditor" it has a right that "can be availed of only by a surety alert in discharging its duty . . . and one not guilty of inequitable conduct." The indenture trustee is not, of course, a surety. It would have to seek subrogation under the general equitable doctrine, stated as follows by the American Law Institute: [1]

> "Where property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the obligee or lien-holder."

It is not imaginable that any court would ever hold that an indenture trustee, found culpably responsible for the default on debentures, would be subrogated with respect to funds which otherwise would go to innocent creditors or stockholders on the ground that paying money to them rather than to it would constitute unjust enrichment. A person "who invokes the doctrine of subrogation must come into court with clean hands." *German Bank* v. *United States*, 148 U. S. 573, 581.

I agree with Judge Kaufman and Judge Hays, dissenting below, and would reverse this judgment.

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[1] Restatement of Restitution § 162 (1937).